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# Not-for-profit organizations with conforming changes as of May 1, 1997; Audit and accounting guide:

American Institute of Certified Public Accountants. Not-for-Profit Organizations Committee

AICPA AUDIT AND ACCOUNTING GUIDE

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# NOT-FOR-PROFIT ORGANIZATIONS

*With Conforming Changes as of May 1, 1997*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**AICPA AUDIT AND ACCOUNTING GUIDE**

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# NOT-FOR-PROFIT ORGANIZATIONS

**With Conforming Changes as of May 1, 1997**

This edition of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations,* which was originally issued in 1996, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page v). The changes made are identified in a schedule in appendix D of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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# NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the AICPA Not-for-Profit Organizations Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

The AICPA Auditing Standards Board has found the descriptions of auditing standards, procedures, and practices in this Audit and Accounting Guide to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. Descriptions of auditing standards, procedures, and practices in Audit and Accounting Guides are not as authoritative as pronouncements of the Auditing Standards Board, but AICPA members should be aware that they may have to justify a departure from such descriptions if the quality of their work is questioned.

G. Michael Crooch, *Chair*
Accounting Standards Executive Committee

Edmund R. Noonan, *Chair*
Auditing Standards Board

**Not-for-Profit Organizations Committee (1995-1996)**



**Not-for-Profit Organizations Committee (1996-1997)**



**AICPA Staff**



The Not-for-Profit Organizations Committee gratefully acknowledges the contributions made to the development, content, and writing of this Audit and Accounting Guide by Alan S. Glazer, Professor of Business Administration, Franklin and Marshall College, and Henry R. Jaenicke, C.D. Clarkson Professor of Accounting, Drexel University.

In developing this Audit and Accounting Guide, the AICPA Not-for-Profit Organizations Committee considered guidance included in the following authoritative pronouncements through May 1, 1997:

- FASB Statements through Statement No. 129, *Disclosure of Information about Capital Structure*
- FASB Interpretations through Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116)
- FASB Technical Bulletins (TB) through TB 94-1, *Application of Statement No. 115 to Debt Securities Restructured in a Troubled Debt Restructuring*
- AICPA Statements of Position (SOP) through SOP 96-1, *Environmental Remediation Liabilities*
- AICPA Practice Bulletins (PB) through PB 15, *Accounting by the Issuer of Surplus Notes*
- Consensus positions of the FASB's Emerging Issues Task Force reached through January 1997
- AICPA Statements on Auditing Standards (SAS) through SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*
- AICPA Statements on Standards for Attestation Engagements (SSAE) through SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2*

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

# Preface

## Purpose

This AICPA Audit and Accounting Guide (Guide) has been prepared to assist nongovernmental not-for-profit organizations in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements.

## Applicability

This Guide applies to organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*.

## Limitations

This Guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of not-for-profit organizations. This Guide is directed primarily to those aspects of the preparation and audit of not-for-profit organizations' financial statements that are unique to those organizations or are considered particularly significant to them.

## Impact on Other Literature

This Guide incorporates certain provisions of FASB Statement Nos. 116 and 117, *Financial Statements of Not-for-Profit Organizations*. Not all guidance that is included in those Statements, however, is incorporated, repeated, or summarized in this Guide. Accordingly, those Statements should be read in conjunction with this Guide. Like FASB Statement Nos. 116 and 117, this Guide is directed at not-for-profit organizations in general, and not at specific kinds of such organizations, such as voluntary health and welfare organizations or private colleges and universities. It is expected that various industry associations will publish guidance on applying both the FASB Statements and this Guide to specific kinds of organizations.[1]

This Guide supersedes the following AICPA Audit and Accounting Guides:[2]

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[1] Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), establishes a hierarchy of sources of GAAP. The hierarchy is described in appendix G [paragraph 1.30] to chapter 1, "Introduction," of this Guide. SAS No. 69 notes that in the absence of established accounting principles described in categories (a)–(d) of the hierarchy of GAAP, the auditor may consider other accounting literature, including pronouncements of other professional associations, depending on its relevance in the circumstances. Guidance published by industry associations may be considered "other accounting literature" in the hierarchy of sources of accounting principles established by SAS No. 69.

[2] As noted previously in this Preface, this Guide applies to nongovernmental not-for-profit organizations. (Paragraph 1.03 of this Guide discusses the determination of whether an entity is a nongovernmental organization.) Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statement Nos. 116 and 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in Statement of Position (SOP) 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*

*(continued)*

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also supersedes the following AICPA SOPs:

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*[3]
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

## Effective Date and Transition

The provisions of this Guide, other than those included in paragraphs 1.06 through 1.17, which are discussed below, are effective for financial statements for fiscal years ending on or after December 31, 1996.[4] Earlier application is permitted.

The provisions included in paragraphs 1.06 through 1.17 are effective for financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is fiscal years beginning after December 15, 1995. Earlier application is permitted.

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*(footnote continued)*

(modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models,* requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities,* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities,* and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.) The applicability of the Industry Audit Guide *Audits of Colleges and Universities* and SOP 74-8 to governmental colleges and universities that use the "AICPA College Guide Model" is unchanged by this Guide.

[3] This Guide supersedes SOP 87-2, because the provisions of SOP 87-2 are incorporated into paragraphs 13.31 through 13.40 of this Guide. On September 10, 1993, the Not-for-Profit Organizations Committee of the AICPA issued an exposure draft of an SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, which would supersede the provisions in paragraphs 13.31 through 13.40 of this Guide.

[4] This Guide does not defer the effective date of any pronouncements that cover not-for-profit organizations.

Unless the provisions of this Guide, other than those included in paragraphs 1.06 through 1.17, are applied retroactively under the provisions of the following paragraph, the effect of initially applying this Guide should be reported as the effect of a change in accounting principle, in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*, paragraph 19). The amount of the cumulative effect should be based on a retroactive computation. Organizations should report the cumulative effect of a change in accounting on each class of net assets in the statement of activities, after the caption "extraordinary items" (if any) and before the captions "change in unrestricted net assets," "change in temporarily restricted net assets," and "change in permanently restricted net assets."

This Guide, other than the guidance in paragraphs 1.06 through 1.17, may be applied retroactively by restating the opening net assets for the earliest year presented or for the year this Guide is first applied if no prior years are presented. In the period in which this Guide is first applied, organizations should disclose the nature of any restatement and its effect on the change in net assets for each period presented.

In implementing the guidance in paragraphs 1.06 through 1.17, which incorporates the provisions of SOP 94-2 into this Guide, the transition rules of the APB Opinions and FASB Statements adopted, other than their effective dates, should be followed. However, if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06 through 1.17, organizations have the option of including the cumulative effect of adopting those accounting principles in the statement of activities in the year this Guide is adopted, regardless of the transition rules of the APB Opinions and FASB Statements adopted,[5] and the financial statements should disclose the nature of the cumulative adjustment. (Paragraphs 19 and 20 of APB Opinion No. 20 discuss reporting the cumulative effects of changes in accounting principles.) In circumstances in which there is more than one change in accounting principle resulting from applying this Guide and the cumulative effect of adopting those accounting principles is included in the statement of changes in net assets in the year the guidance in paragraphs 1.06 through 1.17 is adopted, this Guide does not require the pro forma disclosures required by paragraphs 19(d) and 21 of APB Opinion No. 20.

[5] Organizations that adopt the guidance in paragraphs 1.06 through 1.17 in the same year in which they adopt FASB Statement No. 116 are permitted to apply the provisions of paragraph 17 of that Statement, concerning recognition of expirations of restrictions, prospectively, as specified in that Statement, regardless of whether they report the cumulative effect of adopting other accounting principles as a result of applying the guidance in paragraphs 1.06 through 1.17 of this Guide.

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# Chapter 1
# *Introduction*

## Scope

**1.01** This Audit and Accounting Guide (Guide) covers organizations that meet the definition of a not-for-profit organization included in appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*. That definition is as follows:

> An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (Concepts Statement No. 4, paragraph 7).

As noted in the above definition, not-for-profit organizations have characteristics (*a*), (*b*), and (*c*) in varying degrees. An organization could meet the definition of a not-for-profit organization without possessing characteristic (*a*), (*b*), or (*c*). For example, some not-for-profit organizations, such as those that receive all their revenue from exchange transactions, receive no contributions.

**1.02** The term *not-for-profit organizations* encompasses all entities defined as not-for-profit organizations by FASB Statement No. 116, including the kinds of organizations that were covered by the AICPA Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities*, the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, and American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, which are superseded by this Guide. Accordingly, this Guide applies to nongovernmental not-for-profit organizations of the following kinds:[1]

- Cemetery organizations
- Civic and community organizations
- Colleges and universities
- Elementary and secondary schools

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[1] This list does not necessarily include all organizations that meet the definition of a not-for-profit organization in FASB Statement No. 116. This Guide applies to all organizations that meet the definition, regardless of whether they are included in this list.

- Federated fund-raising organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural organizations
- Performing arts organizations
- Political parties
- Political action committees
- Private and community foundations
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Voluntary health and welfare organizations
- Zoological and botanical societies

**1.03** Paragraph 1.02 provides that this Guide applies to certain nongovernmental not-for-profit organizations. Nongovernmental organizations are all organizations other than governmental organizations. Public corporations[2] and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

*a.* Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;

*b.* The potential for unilateral dissolution by a government with the net assets reverting to a government; or

*c.* The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

**1.04** Not-for-profit organizations that are providers of health care services[3] are not covered by this Guide and should follow the AICPA Audit and Accounting Guide *Health Care Organizations*.

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[2] *Black's Law Dictionary* defines a public corporation as: An artificial person (e.g.,[a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state. Sharon Realty Co. v. Westlake, Ohio Com. Pl., 188 N.E.2d 318, 323, 25 O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. York County Fair Ass'n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.

[3] Providers of health care services that meet the definition of a voluntary health and welfare organization in FASB Statement No. 116 should follow this Guide.

## GAAP Hierarchy for Not-for-Profit Organizations

**1.05** AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411), states that the guidance provided by FASB Statements and Interpretations, Opinions of the Accounting Principles Board (APB), and Accounting Research Bulletins (ARB) shall be considered established accounting principles pursuant to Rule 203 of the AICPA Code of Professional Conduct. (Appendix G [paragraph 1.30] of this chapter discusses SAS No. 69 and the hierarchy of sources of generally accepted accounting principles [GAAP].)

**1.06** Not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations unless the specific pronouncement explicitly exempts not-for-profit organizations or their subject matter precludes such applicability. (As noted in paragraphs 1.11 and 1.12 of this Guide, not-for-profit organizations should follow the guidance in Statement Nos. 116 and 117, *Financial Statements of Not-for-Profit Organizations*, and this Guide in applying the guidance in pronouncements listed in appendixes C and D [paragraphs 1.26 and 1.27] of this chapter.)

**1.07** The appendixes [paragraphs 1.24 through 1.30] of this chapter are aids to the implementation of the guidance in this chapter.

**1.08** Pronouncements issued by the FASB subsequent to this Guide's effective date apply to not-for-profit organizations unless those pronouncements explicitly exempt not-for-profit organizations or their subject matter precludes such applicability.[4]

**1.09** Not-for-profit organizations may follow and are not prohibited from following the guidance in effective provisions of the APB Opinions and the FASB Statements and Interpretations listed in appendix A [paragraph 1.24] of this chapter, which specifically exempt not-for-profit organizations from their application, unless FASB Statement Nos. 116 or 117 or this Guide provide different guidance. (However, the guidance included in the effective provisions of pronouncements listed in appendix A [paragraph 1.24] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities.) The discussion in paragraphs 1.11 through 1.17 of this Guide should be considered in determining the hierarchy of such guidance and of guidance issued by the AICPA.

**1.10** Certain financial reporting guidance listed in appendix B [paragraph 1.25] of this chapter, such as that concerning common stock and convertible debt, generally does not apply to the kinds of entities covered by this Guide, because such entities do not enter into the kinds of transactions covered by that guidance. (However, the guidance included in the effective provisions of pronouncements included in appendix B [paragraph 1.25] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities. Also, not-for-profit organizations should follow the effective provisions of pronouncements in appendix B [paragraph 1.25] if they enter into the kinds of transactions covered by that guidance.)

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[4] The guidance in paragraphs 1.05 through 1.17 of this Guide addresses only the pronouncements listed in paragraph 1.06. However, not-for-profit organizations are also subject to other pronouncements included in categories (b)-(d) of paragraph 5 of SAS No. 69 and should apply AICPA Audit and Accounting Guides, SOPs, and Practice Bulletins and FASB Technical Bulletins and the consensus positions of the FASB Emerging Issues Task Force that apply to them. (Appendix G [paragraph 1.30] of this chapter discusses SAS No. 69 and the GAAP hierarchy.)

1.11 Other pronouncements, which are listed in appendix C [paragraph 1.26] of this chapter (ARB No. 51, *Consolidated Financial Statements*, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*), do not exempt not-for-profit organizations from their scope, but the transactions they contemplate also are covered by FASB Statement No. 116 and this Guide. Statement Nos. 116 and 117 and this Guide provide guidance for applying the pronouncements to circumstances unique to not-for-profit organizations and not contemplated by the pronouncements and therefore should be followed to apply the guidance in those pronouncements to not-for-profit organizations. (However, the guidance included in the effective provisions of pronouncements included in appendix C [paragraph 1.26] should be followed by all for-profit entities owned, whether owned all or in part, by not-for-profit entities.)

1.12 Some pronouncements (listed in appendix D [paragraph 1.27] of this chapter), which may include guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, gains and losses, and financial statement display, state that their provisions apply only to entities operating in certain industries. Such entities generally are business enterprises. An example of such guidance is FASB Statement No. 63, *Financial Reporting by Broadcasters*. However, some not-for-profit organizations conduct activities[5] in some of those industries and should apply the guidance in the pronouncements concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, such not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117 and this Guide, even though it may conflict with display that would result from applying the guidance in the pronouncements listed in appendix D [paragraph 1.27].

1.13 Financial reporting pronouncements that have not been superseded and are not included in appendixes A through D [paragraphs 1.24 through 1.27] of this chapter are listed in appendix E [paragraph 1.28] of this chapter. Not-for-profit organizations should follow the effective provisions of the pronouncements listed in appendix E [paragraph 1.28].[6]

1.14 Certain other pronouncements, although they do not exempt not-for-profit organizations and do cover transactions conducted by not-for-profit organizations, include some provisions whose application by not-for-profit organizations may be unclear. Nevertheless, not-for-profit organizations are required to follow the effective provisions of those pronouncements. These provisions and their applicability are discussed below.

## APB Opinion No. 16, *Business Combinations*

1.15 Because the conditions for applying the pooling of interests method of accounting for a business combination generally include an exchange of common stock of the combining entities, not-for-profit organizations generally would not meet the conditions for applying that method. The AICPA Accounting Standards Executive Committee (AcSEC) believes that circumstances exist under which reporting on the combination of two or more not-for-profit organizations (or that of a not-for-profit organization with a formerly for-profit entity) by the pooling of interests method better reflects the substance of the transac-

[5] Such activities may be conducted by (*a*) for-profit entities owned and consolidated by not-for-profit organizations, (*b*) divisions of not-for-profit organizations, or (*c*) entire not-for-profit organizations, such as those operating as not-for-profit broadcasters.

[6] See footnote 4.

tion than reporting by the purchase method. Therefore, not-for-profit organizations are, under certain circumstances, permitted to report by the pooling of interests method, even though they generally do not issue common stock. Such circumstances include the combination of two or more entities to form a new entity without the exchange of consideration.

**1.16** An example of acceptable practice, in some circumstances, for reporting business combinations by not-for-profit organizations if there has been no exchange of consideration is to report the (*a*) assets, (*b*) liabilities, and (*c*) net asset balances of the combined entities as of the beginning of the year and disclose the information that would be required to be disclosed for a pooling of interests under APB Opinion No. 16.

## Provisions of Certain Pronouncements Concerning Financial Statement Display

**1.17** The following pronouncements include provisions specifying the financial statement display of certain financial statement elements or items such as gains and losses, extraordinary items, translation adjustments, income tax expense, and prepaid or deferred income taxes:

- APB Opinion No. 9, *Reporting the Results of Operations*
- APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*; FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*; and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities**
- APB Opinion No. 30, as amended by FASB Statement No. 128, *Earnings per Share*
- FASB Statement No. 52, *Foreign Currency Translation*
- FASB Statement No. 109, *Accounting for Income Taxes*

None of the preceding pronouncements considers the net asset reporting model included in FASB Statement No. 117 and this Guide. Therefore, preparers of financial statements of not-for-profit organizations should consider the reporting objectives of these APB Opinions and FASB Statements when exercising judgment about how to best display elements, such as in which net asset class.

# Fund Accounting and Net Asset Classes

**1.18** Fund accounting is a technique used by some not-for-profit organizations for purposes of internal recordkeeping and managerial control and to help ensure that the use of resources is in accordance with stipulations imposed

* In June 1996, the FASB issued Statement No. 125, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

by donors and other resource providers and with self-imposed limitations designated by the organization's governing board. Under fund accounting, resources are classified into funds associated with specific activities and objectives. Prior to implementing FASB Statement No. 117, some not-for-profit organizations used fund accounting for financial reporting in conformity with applicable AICPA Industry Audit Guides and Audit and Accounting Guides.

**1.19** *Montgomery's Auditing* notes that "as used in nonprofit accounting, a fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, the fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to ensure that the limitations and restrictions on the use of resources are observed. Though the fund concept involves separate accounting records, it does not entail the physical segregation of resources. Fund accounting is basically a mechanism to assist in exercising control over the purpose of particular resources and amounts of those resources available for use."[7] Fund accounting is discussed further in chapter 16, "Fund Accounting," of this Guide.

**1.20** Paragraph 18, footnote 5, of FASB Statement No. 117 states that "this Statement does not use the terms *fund balance* or *changes in fund balances* because in current practice those terms are commonly used to refer to individual groups of assets and related liabilities rather than to an entity's net assets or changes in net assets taken as a whole...." As discussed in chapter 3, "Basic Financial Statements," of this Guide, FASB Statement No. 117 requires that the amounts for each of three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

**1.21** Therefore, under FASB Statement No. 117, reporting by individual funds or fund groups is not required. FASB Statement No. 117, however, does not preclude providing disaggregated information by individual funds or fund groups, as long as the required aggregated amounts for each of the three classes of net assets are displayed as indicated above. Paragraph 50 of the Statement specifically notes that "...how an organization maintains its internal accounting and recordkeeping systems is a matter outside the purview of the FASB."

**1.22** Some not-for-profit organizations may continue to use fund accounting for purposes other than reporting in conformity with GAAP, and some may provide disaggregated information in the financial statements beyond the minimum requirements of FASB Statement No. 117. A particular fund balance may fall completely into one of the three net asset classes or may be allocated to more than one net asset class, in conformity with the requirements of FASB Statement No. 117 and as discussed in chapter 16 of this Guide.

**1.23** The accounting and auditing issues concerning each particular asset, liability, or class of net assets (financial statement elements) are not a function of the element's internal classification or financial statement subclassification. Accordingly, this Guide is organized by financial statement elements and not by type of fund or groups of funds. Chapter 16 of this Guide contains a discussion of the relationship of an organization's fund balances to its net asset classes.

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[7] Vincent M. O'Reilly, Murray B. Hirsch, Philip L. Defliese, and Henry R. Jaenicke, *Montgomery's Auditing*, 11th ed. (New York: John Wiley & Sons, 1990), 791.

1.24

## Appendix A—Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application

| *Pronouncement* | *Other References, if Any* * | *Status of Other References* |
|---|---|---|
| APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended by APB Opinions 23 and 30 and FASB Statement Nos. 13, 58, 94, 115, 121, and 128, and including FASB Interpretation No. 35[CON] | SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*[CON] | This Guide provides no guidance for the equity method of accounting for common stock. However, it does provide guidance for accounting for investments in common stock. |
| APB Opinion 28, *Interim Financial Reporting*, as amended by FASB Statement Nos. 3, 95, 109, and 128, and including FASB Interpretation No. 18[DIS] | None | None |
| FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements* | None | None |
| FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, as amended by FASB Statement Nos. 18, 21, 24, 30, 95, and 111[CON, DIS] | None | None |
| FASB Statement No. 18, *Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements*[DIS] | None | None |
| FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, as amended by FASB Statement Nos. 95, 123, and 128[DIS] | None | None |
| FASB Statement No. 24, *Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report*, as amended by FASB Statement No. 95 | None | None |
| FASB Statement No. 30, *Disclosure of Information about Major Customers*[DIS] | None | None |

*(Continued)*

## Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application—continued

| *Pronouncement* | *Other References, if Any* * | *Status of Other References* |
|---|---|---|
| FASB Statement No. 89, *Financial Reporting and Changing Prices,* as amended by FASB Statement No. 109[CON] | None | None |
| FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* as amended by FASB Statement Nos. 124 and 125** | FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; Chapter 8 of this Guide | Statement No. 124 is effective for fiscal years beginning after December 15, 1995, and interim periods within those fiscal years |
| FASB Statement No. 128, *Earnings per Share* | None | None |
| FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods,* as amended by FASB Statement Nos. 71, 109, and 111 | None | None |
| FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock* | See APB Opinion 18 | See APB Opinion 18 |

* References in this column are provided as a guide to other sources of information about the topic covered by the listed pronouncement.

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3.

[DIS] On January 19, 1996, the FASB released an exposure draft of a proposed FASB Statement, *Reporting Disaggregated Information about a Business Enterprise*, that would supersede FASB Statement Nos. 14, 18, and 30, and would amend ARB No. 51, APB Opinion 28, and FASB Statement Nos. 21, 51, 69, and 94.

**In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

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## Appendix B—Financial Reporting Pronouncements That, by the Nature of Their Subject Matter, Generally Do Not Apply to Not-for-Profit Organizations

- APB Opinion 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- APB Opinion 25, *Accounting for Stock Issued to Employees*, as amended by FASB Statement Nos. 109 and 123, and including FASB Interpretation Nos. 28 and 38
- FASB Statement No. 84, *Induced Conversions of Convertible Debt*
- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by FASB Statement No. 128
- FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, as amended by FASB Statement Nos. 123 and 128
- FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*, as amended by FASB Statement Nos. 123 and 128

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# Appendix C—Financial Reporting Pronouncements Whose Application to Not-for-Profit Organizations is Subject to Additional FASB or AICPA Guidance

| *Pronouncement* | *Additional Guidance* |
|---|---|
| ARB No. 51, *Consolidated Financial Statements*, as amended by APB Opinions 10, 16, 18, and 23, and FASB Statement Nos. 58, 71, 94, and 111 [CON, DIS] | SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*[CON] |
| APB Opinion 29, *Accounting for Nonmonetary Transactions*, as amended by FASB Statement Nos. 71, 109, and 123, and including FASB Interpretation No. 30[CON] | FASB Statement No. 116 and chapter 5 of this Guide provide accounting guidance for contributions |
| FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*[CON, DIS] | See ARB No. 51 |
| FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* including FASB Interpretation No. 42[AGT] | This Guide |
| FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, as amended by FASB Statement No. 124 | This Guide |
| FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* | This Guide |
| FASB Interpretation No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*, as amended by FASB Statement No. 109 | See APB Opinion 29 |
| FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* | This Guide |

[AGT] On December 29, 1995, the FASB released an exposure draft of a proposed FASB Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116).*

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3.

[DIS] On January 19, 1996, the FASB released an exposure draft of a proposed FASB Statement, *Reporting Disaggregated Information about a Business Enterprise*, that would supersede FASB Statement Nos. 14, 18, and 30, and would amend ARB No. 51, APB Opinion 28, and FASB Statement Nos. 21, 51, 69, and 94.

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## Appendix D—Financial Reporting Pronouncements Pertaining to Specialized Industry Practices of Business Enterprises

This appendix includes pronouncements that apply only to entities operating in certain industries, generally business enterprises. However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses in those pronouncements to the transactions unique to those industries. In addition, those not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, and this Guide, although it may conflict with display that would result from applying the guidance in the pronouncements included in this appendix.

- APB Opinion 12, *Omnibus Opinion—1967* (guidance under the heading "Capital Changes")
- APB Opinion 13, *Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks*
- FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, as amended by FASB Statement Nos. 71 and 95, and including FASB Interpretation No. 7
- FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by FASB Statement Nos. 25, 69, 71, 109, and 121, and including FASB Interpretation Nos. 33 and 36
- FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FASB Statement No. 19)*, as amended by FASB Statement No. 111
- FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement Nos. 75 and 110
- FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers (an amendment of Chapter 5 of ARB No. 43 and an Interpretation of APB Opinions 17 and 30)*, as amended by FASB Statement No. 109
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, as amended by FASB Statement Nos. 71 and 121[DIS]
- FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended by FASB Statement Nos. 91, 97, 109, 113, 114, 115, 120, 121, and 124, and including FASB Interpretation No. 40
- FASB Statement No. 61, *Accounting for Title Plant*, as amended by FASB Statement No. 121
- FASB Statement No. 63, *Financial Reporting by Broadcasters*

- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statement Nos. 91, 115, 124, and 125*
- FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, as amended by FASB Statement Nos. 111 and 121
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities (an amendment of FASB Statements 19, 25, 33, and 39)*, as amended by FASB Statement Nos 89, 95, and 109[DIS]
- FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended by FASB Statement Nos. 90, 92, 109, and 121
- FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions (an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9)*
- FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures (an amendment of APB Opinion No. 20)*
- FASB Statement No. 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units (an amendment of FASB Statement No. 35)*
- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs (an amendment of FASB Statement No. 71)*, as amended by FASB Statement Nos. 92 and 109
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17)*, as amended by FASB Statement Nos. 98, 114, 115, and 124
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans (an amendment of FASB Statement No. 71)*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as amended by FASB Statement Nos. 113, 115, and 120
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, as amended by FASB Statement Nos. 109 and 121
- FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts (an amendment of FASB Statement No. 35)*
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, as amended by FASB Statement No. 120, and including FASB Interpretation No. 40
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (an amendment of FASB Statement Nos. 60, 97, and 113 and Interpretation No. 40)*
- FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises*

- FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method,* as amended by FASB Statement No. 72
- FASB Interpretation No. 33, *Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*
- FASB Interpretation No. 36, *Accounting for Exploratory Wells in Progress at the End of a Period*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises,* as amended by FASB Statement Nos. 115 and 120

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[DIS] On January 19, 1996, the FASB released an exposure draft of a proposed FASB Statement, *Reporting Disaggregated Information about a Business Enterprise,* that would supersede FASB Statement Nos. 14, 18, and 30, and would amend ARB No. 51, APB Opinion 28, and FASB Statement Nos. 21, 51, 69, and 94.

[*] In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.* FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125,* which defers for one year the effective date of certain provisions of FASB Statement No. 125.

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# Appendix E—Financial Reporting Pronouncements Not Subsequently Superseded and Not Included in Appendixes A through D of This Chapter

As stated in paragraph 1.06 of this Guide, not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations, except for specific pronouncements that explicitly exempt not-for-profit organizations and pronouncements for which this Guide provides guidance. This appendix includes pronouncements, not subsequently superseded, that (*a*) do not exempt not-for-profit organizations from their application, (*b*) by the nature of their subject matter, apply to the kinds of transactions not-for-profit organizations engage in, (*c*) are subject to no additional FASB or AICPA guidance, and (*d*) do not pertain to specialized industry practices of business enterprises. Not-for-profit organizations should follow the guidance in the effective provisions of the pronouncements included in this appendix.

- ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* as amended by APB Opinions 6, 9, 10, 16, 17, 20, 21, 25, and 26, and FASB Statement Nos. 5, 6, 44, 52, 78, 94, 109, 111, 115, and 123
- ARB No. 45, *Long-Term Construction-Type Contracts*
- ARB No. 46, *Discontinuance of Dating Earned Surplus*
- APB Opinion 2, *Accounting for the "Investment Credit,"* as amended by APB Opinion 4 and FASB Statement Nos. 71 and 109
- APB Opinion 4 (amending Opinion 2), *Accounting for the "Investment Credit"*
- APB Opinion 6, *Status of Accounting Research Bulletins*, as amended by APB Opinions 16, 17, and 26, and FASB Statement Nos. 52, 71, 109, and 111
- APB Opinion 9, *Reporting the Results of Operations* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by APB Opinions 13, 15, 20, and 30, and FASB Statement No. 16
- APB Opinion 10, *Omnibus Opinion—1966*, as amended by APB Opinions 12, 14, 16, and 18, and FASB Statement Nos. 111 and 129, and including FASB Interpretation Nos. 39 and 41
- APB Opinion 12, *Omnibus Opinion—1967* (except guidance under the heading, "Capital Changes"), as amended by APB Opinion 14 and FASB Statement Nos. 87, 106, and 111
- APB Opinion 16, *Business Combinations* (paragraph 1.15 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 10, 38, 71, 79, 87, 106, 109, and 121, and including FASB Interpretation Nos. 4, 9, and 21[CON]
- APB Opinion 17, *Intangible Assets*, as amended by APB Opinion 30 and FASB Statement Nos. 2, 71, 72, 109, and 121, and including FASB Interpretation No. 9[CON]
- APB Opinion 20, *Accounting Changes*, as amended by FASB Statement Nos. 16, 58, 71, 73, 95, 111, and 128, and including FASB Interpretation Nos. 1 and 20

- APB Opinion 21, *Interest on Receivables and Payables*, as amended by FASB Statement Nos. 34 and 109
- APB Opinion 22, *Disclosure of Accounting Policies*, as amended by FASB Statement Nos. 2, 52, 95, and 111
- APB Opinion 23, *Accounting for Income Taxes—Special Areas*, as amended by FASB Statement Nos. 60, 71, 94, and 109
- APB Opinion 26, *Early Extinguishment of Debt* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by APB Opinion 30 and FASB Statement Nos. 4, 15, 71, 84, and 125*
- APB Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 4, 16, 60, 97, 101, 109, and 128, and including FASB Interpretation No. 27
- FASB Statement No. 2, *Accounting for Research and Development Costs*, as amended by FASB Statement Nos. 71 and 86, and including FASB Interpretation Nos. 4 and 6
- FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt* (an amendment of APB Opinion No. 30) (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 64 and 71
- FASB Statement No. 5, *Accounting for Contingencies*, as amended by FASB Statement Nos. 11, 16, 60, 71, 87, 111, 112, 113, 114, and 123, and including FASB Interpretation Nos. 14 and 34[CON]
- FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced (an amendment of ARB No. 43, Chapter 3A)*, and including FASB Interpretation No. 8
- FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations (an amendment of APB Opinion No. 16)*
- FASB Statement No. 11, *Accounting for Contingencies—Transition Method (an amendment of FASB Statement No. 5)*
- FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement Nos. 22, 23, 27, 28, 29, 34, 71, 91, 94, 98, 109, and 125,* and including FASB Interpretation Nos. 19, 21, 23, 24, 26, and 27
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statement Nos. 71, 111, 114, and 121[CON]
- FASB Statement No. 16, *Prior Period Adjustments*, as amended by FASB Statement Nos. 71 and 109
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)*, as amended by FASB Statement Nos. 71 and 125*
- FASB Statement No. 23, *Inception of the Lease (an amendment of FASB Statement No. 13)*
- FASB Statement No. 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)*

- FASB Statement No. 28, *Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 66
- FASB Statement No. 29, *Determining Contingent Rentals (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 98
- FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement Nos. 42, 58, 62, 71, and 121, and including FASB Interpretation No. 33
- FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes (an amendment of APB Opinion No. 11)*, as amended by FASB Statement No. 109[CON]
- FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises (an amendment of APB Opinion No. 16)* (paragraph 1.15 of this Guide discusses this pronouncement), as amended by FASB Statement No. 109
- FASB Statement No. 42, *Determining Materiality for Capitalization of Interest Cost (an amendment of FASB Statement No. 34)*
- FASB Statement No. 43, *Accounting for Compensated Absences*, as amended by FASB Statement Nos. 71, 112, and 123
- FASB Statement No. 47, *Disclosure of Long-Term Obligations*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements*, as amended by FASB Statement No. 71
- FASB Statement No. 52, *Foreign Currency Translation* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 95 and 109, and including FASB Interpretation No. 37
- FASB Statement No. 57, *Related Party Disclosures*, as amended by FASB Statement Nos. 95 and 109[CON]
- FASB Statement No. 58, *Capitalization of Interest in Financial Statements That Include Investments Accounted for by the Equity Method (an amendment of FASB Statement No. 34)*
- FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants (an amendment of FASB Statement No. 34)*
- FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements (an amendment of FASB Statement No. 4)*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*, as amended by FASB Statement Nos. 98 and 121
- FASB Statement No. 68, *Research and Development Arrangements*
- FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, as amended by FASB Statement Nos. 105 and 125[*]
- FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor (an amendment of ARB No. 43, Chapter 3A)*
- FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (an amendment of APB Opinion No. 16)* (paragraph 1.15 of this Guide discusses this pronouncement)

- FASB Statement No. 80, *Accounting for Futures Contracts*, as amended by FASB Statement No. 115
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- FASB Statement No. 87, *Employers' Accounting for Pensions*, as amended by FASB Statement Nos. 106 and 109
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, as amended by FASB Statement No. 99
- FASB Statement No. 95, *Statement of Cash Flows*, as amended by FASB Statement Nos. 102, 104, and 117
- FASB Statement No. 98, *Accounting for Leases:*
  - *Sale-Leaseback Transactions Involving Real Estate*
  - *Sales-Type Leases of Real Estate*
  - *Definition of the Lease Term*
  - *Initial Direct Costs of Direct Financing Leases*

  *(an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11)*
- FASB Statement No. 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations (an amendment of FASB Statement No. 93)*
- FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (an amendment of FASB Statement No. 95)*, as amended by FASB Statement No. 115
- FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions (an amendment of FASB Statement No. 95)*
- FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement Nos. 107, 111, 119, 123, and 125, and including FASB Interpretation No. 39*
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 112, 119, 123, 125, and 126*
- FASB Statement No. 109, *Accounting for Income Taxes* (paragraph 1.17 of this Guide discusses this pronouncement), as amended by FASB Statement Nos. 115 and 123
- FASB Statement No. 111, *Rescission of FASB Statement No. 32 and Technical Corrections*
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits (an amendment of FASB Statements No. 5 and 43)*, as amended by FASB Statement No. 123

- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statements No. 5 and 15)*, as amended by FASB Statement No. 118
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (an amendment of FASB Statement No. 114)*
- FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended by FASB Statement No. 127*
- FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*
- FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125**
- FASB Statement No. 129, *Disclosure of Information about Capital Structure*
- FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory*, as amended by FASB Statement No. 121
- FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*
- FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, as amended by FASB Statement No. 86
- FASB Interpretation No. 8, *Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
- FASB Interpretation No. 20, *Reporting Accounting Changes under AICPA Statements of Position*, as amended by FASB Statement No. 111
- FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building*
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*
- FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*
- FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*
- FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, as amended by FASB Statement No. 113 and FASB Interpretation No. 41

- FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*

[CON] On October 16, 1995, the FASB released an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Policy and Procedures*, that would supersede ARB No. 51 and FASB Statement No. 94, and would amend APB Opinions 16, 17, 18, and 29, and FASB Statement Nos. 5, 14, 15, 37, 57, and 89, and provide guidance that differs from guidance included in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*.

* In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which supersedes certain pronouncements, including FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the FASB issued Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, which defers for one year the effective date of certain provisions of FASB Statement No. 125.

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## Appendix F—All Financial Reporting Pronouncements, Cross-Referenced by Appendix

| *Pronouncement* | *Appendix* |
|---|---|
| ARB 1 to ARB 42 | Superseded |
| ARB 43 | E |
| ARB 44 | Superseded |
| ARB 44 (Revised) | Superseded |
| ARB 45 | E |
| ARB 46 | E |
| ARB 47 to ARB 50 | Superseded |
| ARB 51 | C |
| APB Opinion 1 | Superseded |
| APB Opinion 2 | E |
| APB Opinion 3 | Superseded |
| APB Opinion 4 | E |
| APB Opinion 5 | Superseded |
| APB Opinion 6 | E |
| APB Opinions 7 and 8 | Superseded |
| APB Opinion 9 | E |
| APB Opinion 10 | E |
| APB Opinion 11 | Superseded |
| APB Opinion 12 | D, E |
| APB Opinion 13 | D |
| APB Opinion 14 | B |
| APB Opinion 15 | Superseded |
| APB Opinion 16 | E |
| APB Opinion 17 | E |
| APB Opinion 18 | A |
| APB Opinion 19 | Superseded |
| APB Opinion 20 | E |
| APB Opinion 21 | E |
| APB Opinion 22 | E |
| APB Opinion 23 | E |
| APB Opinion 24 | Superseded |
| APB Opinion 25 | B |
| APB Opinion 26 | E |
| APB Opinion 27 | Superseded |

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| APB Opinion 28 | A |
| APB Opinion 29 | C |
| APB Opinion 30 | E |
| APB Opinion 31 | Superseded |
| FASB Statement No. 1 | Superseded |
| FASB Statement No. 2 | E |
| FASB Statement No. 3 | A |
| FASB Statement No. 4 | E |
| FASB Statement No. 5 | E |
| FASB Statement No. 6 | E |
| FASB Statement No. 7 | D |
| FASB Statement Nos. 8 and 9 | Superseded |
| FASB Statement No. 10 | E |
| FASB Statement No. 11 | E |
| FASB Statement No. 12 | Superseded |
| FASB Statement No. 13 | E |
| FASB Statement No. 14 | A |
| FASB Statement No. 15 | E |
| FASB Statement No. 16 | E |
| FASB Statement No. 17 | Superseded |
| FASB Statement No. 18 | A |
| FASB Statement No. 19 | D |
| FASB Statement No. 20 | Superseded |
| FASB Statement No. 21 | A |
| FASB Statement No. 22 | E |
| FASB Statement No. 23 | E |
| FASB Statement No. 24 | A |
| FASB Statement No. 25 | D |
| FASB Statement No. 26 | Superseded |
| FASB Statement No. 27 | E |
| FASB Statement No. 28 | E |
| FASB Statement No. 29 | E |
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| FASB Statement Nos. 31 to 33 | Superseded |
| FASB Statement No. 34 | E |
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| FASB Statement No. 37 | E |
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| FASB Statement Nos. 39 to 41 | Superseded |
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| FASB Statement No. 43 | E |
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| FASB Statement No. 45 | D |
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| FASB Statement No. 52 | E |
| FASB Statement No. 53 | D |
| FASB Statement Nos. 54 to 56 | Superseded |
| FASB Statement No. 57 | E |
| FASB Statement No. 58 | E |
| FASB Statement No. 59 | Superseded |
| FASB Statement No. 60 | D |
| FASB Statement No. 61 | D |
| FASB Statement No. 62 | E |
| FASB Statement No. 63 | D |
| FASB Statement No. 64 | E |
| FASB Statement No. 65 | D |
| FASB Statement No. 66 | E |
| FASB Statement No. 67 | D |
| FASB Statement No. 68 | E |
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| FASB Statement No. 71 | D |
| FASB Statement No. 72 | D |
| FASB Statement No. 73 | D |
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| FASB Statement No. 85 | Superseded |
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| FASB Statement No. 89 | A |
| FASB Statement No. 90 | D |
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| FASB Statement No. 96 | Superseded |
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| FASB Statement No. 98 | E |
| FASB Statement No. 99 | E |
| FASB Statement No. 100 | Superseded |
| FASB Statement No. 101 | D |
| FASB Statement No. 102 | E |
| FASB Statement No. 103 | Superseded |
| FASB Statement No. 104 | E |
| FASB Statement No. 105 | E |
| FASB Statement No. 106 | E |
| FASB Statement No. 107 | E |
| FASB Statement No. 108 | Superseded |
| FASB Statement No. 109 | E |
| FASB Statement No. 110 | D |
| FASB Statement No. 111 | E |
| FASB Statement No. 112 | E |
| FASB Statement No. 113 | D |
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| FASB Statement No. 121 | E |
| FASB Statement No. 122 | Superseded |
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| FASB Interpretation No. 1 | E |
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| FASB Interpretation Nos. 10 to 13 | Superseded |
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| FASB Interpretation No. 21 | E |
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# Appendix G—The Hierarchy of GAAP

SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, establishes the hierarchy of GAAP.

For financial statements of entities other than governmental entities, the hierarchy is summarized as follows:

*Category (a).* Rule 203 literature consists of officially established accounting principles, which are FASB Statements and Interpretations, APB Opinions, and ARBs.

*Category (b).* This consists of FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides, and AICPA SOPs.

*Category (c).* This consists of AICPA AcSEC Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB EITF.

*Category (d).* This consists of AICPA accounting interpretations and implementation guides ("Qs and As") published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

If the accounting treatment of a transaction or event is not specified by Rule 203 literature, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

# Chapter 2

# *General Auditing Considerations*

## Scope of Services

**2.01** The scope of services rendered by independent auditors depends on the kinds of reports to be issued as a result of the engagement. For each audit engagement, the auditor and the not-for-profit organization should establish an understanding, preferably in writing, of the scope of services to be performed and the reports to be issued. The not-for-profit organization, after discussions with the auditor, should be sure that in addition to encompassing the financial statements, the scope of the engagement satisfies all relevant contractual, legal, and regulatory requirements. For example, the auditor may be engaged to issue reports that meet requirements found in *Government Auditing Standards* (often called the Yellow Book) issued by the Comptroller General of the United States.[1] Also, the auditor may be engaged to perform tests and issue reports required by the Single Audit Act Amendments of 1996 and United States Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*.[2] The auditor may also be engaged to prepare special reports on various financial data prepared by the organization, such as those related to bond indentures and other debt instruments and annual state information returns required by state attorneys general.

**2.02** Paragraphs 21 through 23 of Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801), provide guidance on the auditor's responsibilities when he or she becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. SAS No. 74 provides that in that situation "the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements." SAS No. 74 also notes that "the auditor should consider how the client's actions in response to such communication relate to

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[1] In practice, the standards included in *Government Auditing Standards* (1994 revision) are sometimes referred to as generally accepted government auditing standards (GAGAS). *Government Auditing Standards* includes standards for performance audits as well as standards for financial audits. The references to *Government Auditing Standards* in this Audit and Accounting Guide (Guide) pertain only to the standards for financial audits.

[2] OMB Circular A-133 includes requirements that the auditor perform tests and report on compliance with the cost principles and matching or cost-sharing requirements set forth in various other government regulations, such as OMB Circulars A-21, *Cost Principles for Colleges and Universities*; A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*; and A-122, *Cost Principles for Nonprofit Organizations*. (A revised OMB Circular A-133 was finalized on April 22, 1996, and subsequently revised and re-exposed for comments on November 5, 1996 to incorporate state and local governments and to comply with other requirements of the Single Audit Act Amendments of 1996. The revised OMB Circular A-133, which is expected to be issued in final form in June 1997, will be effective for audits of fiscal years beginning after June 30, 1996. The discussion of the requirements of OMB Circular A-133 in this Guide pertains to audits of fiscal years after that effective date.)

other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54 [*Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)]."

## Independence

**2.03** Members of the AICPA who are engaged to audit the financial statements of not-for-profit organizations in accordance with generally accepted auditing standards (GAAS) are required to be independent. In making judgments about whether they are independent, members should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct, its Interpretations, and the Ethics Rulings under it. A number of Ethics Interpretations specifically address matters of independence as it relates to not-for-profit organizations.

## Audit Planning

**2.04** The first standard of fieldwork requires that the audit be adequately planned. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides broad guidance about audit risk and materiality at both the financial statement level and at the individual account-balance or class-of-transaction level when the auditor plans and performs an audit. Other authoritative pronouncements provide more specific guidance on planning considerations. This section discusses how that guidance should be applied in audits of not-for-profit organizations.

**2.05** SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." The auditor plans the audit to obtain reasonable assurance of detecting misstatements that could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. SAS No. 47 notes that the auditor needs to consider audit risk at the individual account balance or class-of-transaction level to assist in determining the scope of auditing procedures for the balance or class and related financial statement assertions.

**2.06** The auditor seeks to restrict audit risk at the individual account balance or class-of-transaction level in such a way as to enable the expression of an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. At the account balance or class-of-transaction level, audit risk consists of inherent risk, control risk, and detection risk, which are defined in SAS No. 47. This section describes inherent risk and control risk factors particularly relevant to the audit of a not-for-profit organization that the auditor should consider in planning the audit. (Later sections of this chapter as well as other chapters in the Guide discuss substantive tests unique to the industry that the auditor of a not-for-profit organization should consider in order to reduce detection risk.)

### Industry Characteristics

**2.07** The operations of not-for-profit organizations differ from those of for-profit entities in several significant ways, and those differences affect audit planning. Not-for-profit organizations use their resources to accomplish the purpose or mission for which they exist, not to generate net income. These resources often come from contributions, grants, or appropriations, some of which may be subject to limitations on how the resources may be used.[3] These limitations, which may be imposed by donor restrictions, by contractual terms, or by the organization's governing board, may require the auditor to test expenditures for compliance with relevant limitations.

**2.08** Not-for-profit organizations are also required to comply with numerous other provisions of statutes, contractual agreements, terms of grants and trust agreements, and similar limitations. As discussed later in this chapter, the auditor is typically required to test for compliance with some of these provisions as well. Finally, though not-for-profit organizations are usually eligible for tax-exempt status under Section 501 of the Internal Revenue Code (IRC), the auditor should be aware that income from activities not related to a not-for-profit organization's exempt purpose may be subject to tax and that the organization may own or control for-profit subsidiaries. Taxes on unrelated business income and other tax matters that the auditor should consider in planning an audit of a not-for-profit organization are addressed in chapter 15, "Tax Considerations," of this Guide.

**2.09** Not-for-profit organizations often have revenue and expenditure transactions that are unique to the industry, and these transactions have attendant implications for audit planning. For example, some not-for-profit organizations solicit contributions from various sources, some receive revenues from grants, and some organizations collect dues from members. Fund-raising may take place through telemarketing, direct mail solicitations, door-to-door solicitations, telethons, various kinds of special events, and other activities. Some organizations collect substantial amounts of contributions in the form of currency. Each of these sources of cash flows is associated with different kinds of risk. On the expenditure side, some not-for-profit organizations must also comply with restrictions imposed by resource providers. The revenue and expenditure transaction cycles of not-for-profit organizations may also include transactions that are similar to those entered into by for-profit enterprises—for example, buying and selling merchandise, purchasing investments, property and equipment, and other assets; providing services for fees, and earning income from investments. These cycles may include transactions that do not immediately result in revenues and expenses.

**2.10** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, requires not-for-profit organizations to recognize agreements for future nonreciprocal transfers of cash, other assets, and services that are unconditional (that is, promises to give). Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses recognition and measurement principles for the assets and revenues related to such transactions. Applying those principles often involves the use of significant accounting estimates. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support those estimates.

**2.11** Not-for-profit organizations also have unique reporting requirements under generally accepted accounting principles (GAAP). For example,

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[3] As used in this Guide, *limitation* refers broadly to any constraints imposed on the use of assets or net assets, *restriction* refers to donor-imposed limitations, and *designation* refers to governing-board-imposed limitations.

they must report their expenses by function, such as major classes of program services and supporting activities, in conformity with FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. They are also subject to specific disclosure requirements under FASB Statement No. 116, such as disclosures about promises to give, contributed services, and collections.

**2.12** Each of these kinds of transactions and reporting requirements creates audit risk that the auditor should address. Each also requires the auditor to consider management's implicit financial statement assertions and to formulate specific audit objectives based on those assertions. Not-for-profit organizations usually have controls designed to achieve control objectives related to these transactions.

**2.13** Many not-for-profit organizations face financial and operating pressures that are similar to those faced by for-profit enterprises. Not-for-profit organizations may also face pressures that are unique to institutions that seek revenues in the form of contributions and grants, transactions that often depend on the state of the economy. These pressures generate operating, financial, and accounting responses by management, and such responses may increase both inherent risk and control risk, which the auditor should recognize and respond to in planning the audit. The following are examples:

- Certain donors may tie contribution allocation formulas to the organization's actual or budgeted revenues, leading management to attempt to manage revenues to achieve the largest allocation possible.
- A sluggish economy may reduce contributions and the collection of promises to give that were made in prior years. The reduced receipts may lead the organization to pursue a more aggressive investment strategy involving complex financial instruments. Accounting for these instruments may increase the risk of financial statement misstatements; the auditor should understand the substance of these instruments and determine that they are reported in conformity with GAAP.
- Adverse demographics may lead an organization that charges fees for its services to pursue a more aggressive marketing strategy in its quest for constituents; this could decrease the collectibility of its receivables.
- Shortfalls in unrestricted contributions may induce an organization to use restricted contributions for purposes that violate donor restrictions.
- Acceptance by an organization of federal research and other grants carries with it an obligation to comply with federal regulations when the organization administers those grants. Such regulations include those governing overhead and other costs charged to these grants. The terms of the grants may induce organizations to charge unallowable costs to the grants, possibly resulting in liabilities for fines and repayment of any unallowable costs.
- An attempt to appear as efficient as possible may increase the likelihood of misstatement of the allocation of costs between program services and supporting activities. (Because some financial statement users view program expenses more favorably than supporting services, some not-for-profit organizations have incentive to report costs as program rather than supporting services.)

## Organization Characteristics

**2.14** Effective audit planning requires (*a*) an understanding of the industry in which a particular not-for-profit organization operates and (*b*) knowledge of the specific entity being audited and its uniqueness in relation to the industry. That knowledge should include understanding the way the entity is organized and its operating characteristics (including the level of involvement and oversight exercised by the governing board), sources of revenues, principal expenditures, accounting policies, methods used to process accounting information, and related controls. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides further guidance on matters that the auditor should consider in planning the engagement.

## Internal Control Considerations

**2.15** SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the objectives and components of an entity's internal control and explains how an auditor should consider internal control in planning and performing an audit. SAS No. 55, as amended, requires that to plan the audit, the auditor should obtain an understanding of the entity's internal control sufficient to plan the audit.

**2.16** SAS No. 78 defines internal control as "a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations."[4] The five components of an entity's internal control are the following:

*a.* The control environment

*b.* Risk assessment

*c.* Control activities

*d.* Information and communication

*e.* Monitoring

SAS No. 55, as amended, discusses each of these five components.

**2.17** The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether the controls have been placed in operation. The auditor's primary consideration, however, is whether a specific control affects financial statement assertions rather than its classification into any particular component.

**2.18** The auditor should assess control risk for the assertions embodied in the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the organization's internal control) if the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or if evaluating their ef-

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[4] Paragraph 9 of SAS No. 78 provides that "although an entity's internal control addresses objectives in each of the categories referred to in paragraph 6, not all of these objectives and related controls are relevant to an audit of the entity's financial statements."

fectiveness would be inefficient. Alternatively, the auditor may obtain evidence from tests of controls about the effectiveness of both the design and operation of a control that would support a lower assessed level of control risk. Tests of controls may be performed concurrently with obtaining the understanding (either as a result of audit planning or not), or they may be performed after obtaining an understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests to be performed.

**2.19** Certain characteristics of internal control, particularly in the control environment, may be unique to not-for-profit organizations. SAS No. 78 states that auditors should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment considering both the substance of controls and their collective effect. The following are examples of characteristics of a not-for-profit organization's control environment that the auditor should consider in obtaining an understanding of that environment:

- The role of management and the governing board
- The frequency of governing board meetings
- The qualifications of management and governing board members
- The governing board members' involvement in the organization's operations
- The organizational structure

**2.20** The other four components of internal control of not-for-profit organizations may also include characteristics that would not ordinarily exist in for-profit entities. The auditor should obtain sufficient knowledge of the other four components to understand how—

- Restricted contributions are identified, evaluated, and accepted.
- Promises to give are valued and recorded.
- Contributed goods, services, utilities, facilities, and the use of long-lived assets are valued and recorded.
- Compliance with donor restrictions and board designations is monitored.
- Reporting requirements imposed by donors, contractors, and regulators are met.
- Conformity with accounting presentation and disclosure principles, including those related to functional and natural expense reporting and allocation of joint costs, is achieved.
- New programs are identified and accounted for.

## Analytical Procedures

**2.21** SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires that analytical procedures be applied "to assist the auditor in planning the nature, timing, and extent of other auditing procedures." Analytical procedures are required in the planning and overall review phases of the audit. Analytical procedures applied at the planning stage may be similar to those applied as substantive tests and in the final review stage of the audit, but they generally use more highly aggregated, unaudited data whose reliability is unknown to the auditor because control risk associated with the data has not always been assessed at the planning stage.

**2.22** SAS No. 56 provides examples of sources of information that can be used to develop the necessary expectations for applying analytical procedures. The sources of information that may be unique to not-for-profit organizations are (1) "information regarding the industry in which the client operates" and (2) "relationships of financial information with relevant nonfinancial information." The first of these requires industry-wide data to be used for comparisons (such as data on endowment return, contributions, or program, fund-raising, and management and general costs that can be obtained from industry trade and professional associations). The second requires the auditor to formulate relevant relationships that are usually unique to a particular type of not-for-profit organization, such as the relationship that might be expected to exist at a college or university between the number of students registered at standard tuition rates and tuition revenues, the relationship between the number of members in an organization and its dues revenue, and the relationship between stagehand costs and the number of theatrical, dance, orchestral, or similar performances. These analytical procedures may be applied in all phases of the audit.

## Related-Party Transactions

**2.23** Obtaining knowledge of the client's organization and operations should include performing the procedures in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), to determine the existence of related-party relationships and transactions with such parties and to examine those transactions. The auditor of a not-for-profit organization should be aware that the definition of related parties in FASB Statement No. 57, *Related Party Disclosures*, includes an organization's management and members of management's immediate family, as well as affiliated entities. Accordingly, transactions with brother-sister organizations and certain national and local affiliates as well as entities whose officers or directors are members of the not-for-profit organization's governing board may have to be disclosed under FASB Statement No. 57.

**2.24** SAS No. 45 provides guidance on, among other matters, procedures that the auditor should consider to identify related party relationships and transactions and to obtain satisfaction about the related financial statement reporting and disclosure. Obtaining that information will be enhanced if the organization has a policy that requires an annual written disclosure by governing board members of the details of their transactions and other business involvements with the organization, as well as disclosure of their other board memberships. Some states require that these kinds of disclosures be made on the annual reporting form filed by the organization.

**2.25** Some states have exhibited a heightened concern about whether the governing board members of not-for-profit organizations are meeting their stewardship responsibilities, particularly if there are potential conflicts between the governing board members' financial interests and their duties as governing board members. Responses by an organization to that concern might include increased sensitivity when it enters into business relationships with governing board members and might include developing appropriate controls for addressing potential conflicts of interests that could arise in related-party transactions and for ensuring that such transactions are disclosed to and approved by the governing board.

## Errors and Irregularities

**2.26** Adequate audit planning includes considering the risk that the financial statements could be materially misstated as the result of (*a*) errors, (*b*) irregularities, or (*c*) illegal acts having a direct and material effect on the financial statements. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities** (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), provides guidance on the auditor's responsibility for detecting and communicating information about errors and irregularities. SAS No. 53 describes factors that influence the auditor's ability to detect errors and irregularities and provides guidance on communicating detected errors and irregularities both within and outside the entity being audited. Management, operating and industry, and engagement characteristics that may indicate an increased risk of possible errors and irregularities in an audit of the financial statements are described in paragraphs 10 through 13 of SAS No. 53. That risk may be increased for not-for-profit organizations because of the factors discussed earlier in this section under "Industry Characteristics," "Organization Characteristics," and "Internal Control Considerations."

## Illegal Acts and Compliance Auditing Under GAAS

**2.27** Compliance auditing is designed to determine whether an organization has violated laws, regulations, or contractual requirements. The auditor's responsibilities for performing compliance auditing procedures in an audit of financial statements in accordance with GAAS is described in SAS No. 54. SAS No. 54 prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by a client. It also provides guidance on the auditor's responsibilities when a possible illegal act is detected, including the responsibility to be assured that the audit committee or its equivalent is adequately informed about illegal acts that come to the auditor's attention.

**2.28** SAS No. 54 notes that illegal acts vary considerably in their relation to the financial statements. Some laws and regulations—such as sections of the tax law that affect tax provisions and accruals because of unrelated business income, and government regulations that affect the amount of revenue accrued under government contracts—may have a direct and material effect on the determination of financial statement amounts. The auditor's responsibility to detect misstatements resulting from direct-effect illegal acts is the same as for errors and irregularities. Accordingly, management should identify federal, state, and local laws and regulations that may have a direct and material effect on the determination of financial statement amounts. The auditor should assess the appropriateness of that identification and obtain an understanding of the possible effects of those laws and regulations on the financial statements.

**2.29** Not-for-profit organizations frequently receive financial assistance—such as grants, loans, loan guarantees, and interest-rate subsidies—from federal, state, and local governmental entities. By accepting such assistance, organizations often become subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements. Such laws and regulations may specifically address (*a*) the types of goods or services that organizations may purchase with the assis-

* SAS No. 53 is superseded by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatements, whether caused by error or fraud, and provides guidance on what should be done to meet those responsibilities. SAS No. 82 was issued in February 1997 and is effective for audits of financial statements for periods ending on or after December 15, 1997, with earlier application permitted. In addition SAS No. 82 amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 1, sections 110, *Responsibilities and Functions of the Independent Auditor*, and 230, *Due Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU secs. 110 and 230). This Guide will be amended to conform to SAS No. 82 nearer to the pronouncement's effective date.

tance, (*b*) the eligibility of those to whom organizations may provide benefits, (*c*) amounts organizations must contribute from their own resources toward projects for which financial assistance is provided, and (*d*) principles and standards for determining the direct and indirect costs that are allowable as charges to governmental financial assistance programs.

**2.30** Other laws and regulations relate more to an organization's operating aspects than to its financial and accounting aspects, and violations of these laws and regulations have only an indirect effect on the financial statements. (The indirect effect is usually limited to the need to disclose a contingent liability under FASB Statement No. 5, *Accounting for Contingencies*, because of the allegation or determination of illegality and the possibility of fines, penalties, or damages.) Such laws and regulations may concern securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, or antitrust violations. An example particular to the not-for-profit environment might be the requirement that an organization inform contributors of the portion of their contributions that is tax deductible; the failure to do so could subject the organization to financial penalties. SAS No. 54 does not require the auditor to design auditing procedures to detect illegal acts that do not have a direct and material effect on the financial statements; SAS No. 54 refers to these acts simply as "illegal acts." SAS No. 54 specifies the auditor's responsibilities when he or she becomes aware of information concerning illegal acts.

## Compliance Auditing Under *Government Auditing Standards*

**2.31** Not-for-profit organizations that receive government financial assistance may be required to have audits in accordance with government auditing standards, as specified in the Yellow Book.[5] Government auditing standards pertain to auditors' professional qualifications, the quality of the work performed, and the characteristics of the reports issued. In performing an audit in accordance with the Yellow Book, the auditor assumes reporting responsibilities beyond those required by GAAS. The auditor must report on compliance with laws and regulations, violations of which may affect financial statement amounts, and on the organization's internal control over financial reporting.

## Single Audits and Related Considerations

**2.32** OMB Circular A-133 also prescribes audit requirements for not-for-profit organizations receiving federal awards. An audit under Circular A-133 is described as a "single audit."[6] The audit requirements of Circular A-133 vary with the amount of federal awards an organization receives.[7]

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[5] Though government auditing standards primarily apply to federal financial assistance, some states have adopted government auditing standards.

[6] A single audit is an audit of an entity's financial statements and of compliance with federal regulations relating to federal financial assistance, such as the audits required by Single Audit Act of 1984, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133. Program-specific audits may be conducted in accordance with specific government audit guides, such as the U.S. Department of Education's Audit Guide, *Compliance Audit (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions*.

[7] OMB Circular A-133 requires not-for-profit organizations that expend $300,000 or more in federal awards in a year to have an audit in accordance with the Circular. (Generally, organizations that expend $300,000 or more, but under only one program, have the option of having a program-specific audit or a single audit in accordance with OMB Circular A-133.) Organizations that expend less than $300,000 must maintain records and make them available for review, if requested, but they are exempt from OMB Circular A-133 audit requirements.

**2.33** For audits performed in accordance with OMB Circular A-133, the auditor has responsibilities specified in the circular that go beyond GAAS. In such audits, the auditor must perform additional procedures to test and report on compliance with specified laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on major federal award programs (as defined in the circular). Other requirements of OMB Circular A-133 include reports on the financial statements, on the supplementary schedule of expenditures of federal awards, and on internal control relevant to major federal award programs.

**2.34** SAS No. 74 and Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*,[8] provide guidance on testing and reporting on compliance with laws and regulations in engagements performed under GAAS, the Yellow Book, and OMB Circular A-133. They provide auditors of not-for-profit organizations with a basic understanding of the work they should do and the reports they should issue under the Yellow Book and OMB Circular A-133. (Auditors may be asked to report on either (*a*) an organization's compliance with specified requirements of state and local laws, regulations, contracts, and grants or (*b*) the effectiveness of the organization's internal control over compliance with specified requirements. In such circumstances, auditors should refer to Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), which provides guidance for engagements to report on management's written assertion about such matters. SSAE No. 3, as amended by SAS No. 74, also applies to engagements for which the terms specify an attestation report.)

## Processing of Transactions by Service Organizations

**2.35** In addition to transactions, such as discretionary investment management services and payroll, for which for-profit organizations might use service organizations, not-for-profit organizations may also use such organizations to process transactions, such as student financial aid payments and receipt of contributions, that are unique to that industry. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors the auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. The auditor should also consider the not-for-profit organization's compliance with laws, regulations, and contractual agreements that may apply when service organizations are used to process transactions.

## Using the Work of a Specialist

**2.36** Organization management or the auditor may engage a specialist to provide special skill or knowledge about complex or subjective matters that are potentially material to the financial statements. Auditors of not-for-profit organizations, for example, may need to use the work of a specialist with re-

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[8] SOP 92-9 is included as appendix B of this Guide. SOP 92-9 provides guidance on OMB Circular A-133 audits for periods beginning prior to July 1, 1996, the effective date of the Single Audit Act Amendments of 1996. The AICPA is currently updating SOP 92-9 for the Single Audit Act Amendments of 1996 and OMB Circular A-133 requirements (see footnote 2 in this chapter). The AICPA expects to issue revised guidance in the summer of 1997, subject to OMB issuing a final revised Circular A-133.

spect to the valuation of contributed assets, particularly contributed collection items that the organization capitalizes. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to an auditor who uses the work of a specialist.

## Planning Stage Materiality

**2.37** SAS No. 47 states that "the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements." Expenditures of not-for-profit organizations are often tightly controlled and based on the concept of a balanced budget, with relatively small or zero *operating* margins. As a result, the auditor may consider materiality for planning purposes from various perspectives, such as total net assets, various net asset classes, changes in net assets, changes in net asset classes, total revenues, revenues of each net asset class, total expenses, or other measures—such as total unrestricted contributions, total program expenses, the ratio of program expenses to total expenses, and the ratio of fund-raising expenses to contributions.

**2.38** In an audit of compliance with requirements governing major federal award programs in accordance with OMB Circular A-133, materiality should be considered in terms of each major program.[9] For example, materiality could be considered in relation to the separate assets, revenues, or expenditures of each program that is being reported on.

# Audit Objectives and Audit Procedures

**2.39** The auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning management's assertions embodied in the financial statements. Those assertions may be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, valuation and allocation, and presentation and disclosure. The assertions also serve as broad audit objectives.

**2.40** The purpose of the specific audit objectives, examples of controls, and examples of auditing procedures in the tables presented in the auditing sections of several of the following chapters is to assist the auditor in understanding internal control, assessing control risk, and performing auditing procedures. The tables include only those matters that are unique to not-for-profit organizations. Accordingly, they should not be considered a complete listing of all of the audit objectives, controls, and auditing procedures that the auditor should consider when auditing a not-for-profit organization. In addition, the absence of examples of selected controls related to a particular financial statement assertion is intended to indicate that the assertion does not ordinarily lend itself to specific controls that would provide reasonable assurance that the related audit objective has been achieved.

**2.41** There is not necessarily a one-to-one relationship between audit objectives and auditing procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be necessary to achieve a single objective. The tables are not intended to be all-inclusive

[9] [Footnote deleted.]

or to suggest that specific audit objectives, controls, and auditing procedures should be applied. Some of the audit objectives may not be relevant to a particular organization because of the nature of its operations or the absence of certain types of transactions. The absence of one or more of the illustrative controls would not necessarily indicate a deficiency in internal control.

**2.42** Many of the illustrative controls are premised on the existence of certain essential characteristics of internal control: for example, authorization of transactions, segregation of duties, documentation, supervision and review, and timeliness of controls. To avoid repetition, these characteristics have not been explicitly incorporated in the tables.

# Completing the Audit

**2.43** The procedures involved in completing the audit include the following:

- Performing analytical procedures in the overall review stage
- Summarizing and evaluating possible audit adjustments
- Obtaining legal letters
- Reviewing for subsequent events
- Obtaining written management representations
- Evaluating whether there is a substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time
- Preparing the auditor's reports
- Communicating reportable conditions, errors and irregularities, illegal acts, and matters that may be required by SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)

This section of the Guide discusses aspects of these procedures that are unique to not-for-profit organizations.

## Client Representations

**2.44** SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain certain written representations from management. In addition to the representations contained in the illustrative letter in SAS No. 19, the auditor should consider obtaining representations about the following matters, if applicable, when auditing not-for-profit organizations:

- Compliance with contractual agreements, grants, and donor restrictions
- Maintenance of an appropriate composition of assets in amounts needed to comply with all donor restrictions
- Taxation and tax-exempt status
- Reasonableness of bases for allocation of functional expenses
- Inclusion in the financial statements of all assets and liabilities under the entity's control
- Adequacy of internal control over the receipt and recording of contributions
- Propriety of reclassifications between net asset classes
- The governing board's interpretation concerning whether laws place restrictions on net appreciation of donor-restricted endowments.

**2.45** Paragraph 7 of SAS No. 74 notes that an auditor who has been engaged to audit an organization that receives government funds that make it subject to government-imposed compliance testing and reporting requirements of the Yellow Book should consider obtaining written representations from management concerning the completeness of management's identification of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

**2.46** SOP 92-9 lists representations that should ordinarily be obtained in a single audit required by OMB Circular A-133.

## Going-Concern Considerations

**2.47** SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in meeting the responsibility to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 gives examples of conditions and events that might indicate that there could be substantial doubt about the entity's continued existence. Additional examples of such conditions and events that are particularly applicable to not-for-profit organizations include the following:

- Insufficient unrestricted revenues to provide supporting services to activities funded by restricted contributions
- A high ratio of fund-raising expenses to contributions received or a low ratio of program expenses to total expenses
- Insufficient resources to meet donor's restrictions (This may result from the use of restricted net assets for purposes that do not satisfy the donor's restrictions, sometimes referred to as interfund borrowing.)
- Activities that could jeopardize the organization's tax-exempt status and thus endanger current contribution levels
- Concerns expressed by governmental authorities regarding alleged violations of state laws governing an organization's maintenance or preservation of certain assets, such as collection items
- A loss of key governing board members or volunteers
- External events that could affect donors' motivations to continue to contribute
- Decreases in revenues contributed by repeat donors
- A loss of major funding sources

# Chapter 3

# *Basic Financial Statements*

## Introduction

**3.01** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, establishes standards for general-purpose external financial statements prepared by not-for-profit organizations. It specifies that a complete set of financial statements should include a statement of financial position, a statement of activities, a statement of cash flows,[1] accompanying notes to the financial statements, and for voluntary health and welfare organizations, a statement of functional expenses.[2] Appendix C of FASB Statement No. 117 includes illustrations of those financial statements.

**3.02** A set of financial statements of a not-for-profit organization should include information required by generally accepted accounting principles (GAAP), except for principles included in authoritative pronouncements that specifically exempt not-for-profit organizations,[3] including information required by applicable specialized accounting and reporting principles and practices, such as those specified in this Guide. The requirements of FASB Statement No. 117 are generally no more stringent than the requirements for for-profit organizations; accordingly, although FASB Statement No. 117 does not specify the degree of aggregation and the order of presentation in financial statements of not-for-profit organizations, they should be similar to what is required or permitted for for-profit organizations. Appendix C to FASB Statement No. 117 includes financial statements that illustrate some of the ways in which the requirements of the Statement can be met.

## Statement of Financial Position

**3.03** A statement of financial position should focus on the organization as a whole and should report the amounts of its assets, liabilities, and net assets. Assets and liabilities should be aggregated into reasonably homogeneous groups. Assets need not be disaggregated on the basis of the presence of donor-

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[1] As discussed in chapter 5, "Contributions Received and Agency Transactions," of this Audit and Accounting Guide (Guide), some not-for-profit organizations receive resources in agency transactions. For some of those organizations, receiving resources as agents may be a primary component of their mission. Those organizations should consider presenting the statement of cash flows as the first financial statement presented in their set of financial statements, in order to emphasize the importance of the information presented in that statement.

[2] The terms *statement of financial position*, *statement of activities*, and *statement of functional expenses* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a *balance sheet* as well as a *statement of financial position*. Current practice and the statement's purpose suggest, however, that a statement of cash flows only be titled "Statement of Cash Flows."

[3] Chapter 1, "Introduction," of this Guide, incorporates Statement of Position (SOP) 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which is superseded by this Guide for organizations that are included in the scope of this Guide.

imposed restrictions on their use; for example, cash available for unrestricted current use need not be reported separately from cash received with donor-imposed restrictions that is also available for current use.[4] However, cash or other assets either (*a*) designated for long-term purposes or (*b*) received with donor-imposed restrictions that limit their use to long-term purposes should not be aggregated on a statement of financial position with cash or other assets that is available for current use. For example, cash that has been received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets should be reported under a separate caption, such as "cash restricted to investment in property and equipment," and displayed near the section of the statement where property and equipment is displayed. The kind of asset should be described in the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

**3.04** Paragraph 12 of FASB Statement No. 117 requires that one or more of the following techniques be used to provide information about the organization's liquidity:

*a.* Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash

*b.* Classifying assets and liabilities as current and noncurrent, as defined by Accounting Research Bulletin No. 43, Chapter 3A, "Working Capital—Current Assets and Current Liabilities"

*c.* Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets

Information about the liquidity or maturity of assets and liabilities should be disclosed in a separate note to the financial statements if that information is not apparent from the face of the statements or the other notes.

**3.05** A statement of financial position should report amounts for each of three classes of net assets (permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets) as well as total net assets. The three net asset classes should be based solely on the existence or absence of donor-imposed restrictions. (As discussed in paragraph 3.07, board-designated limitations on the use of unrestricted net assets are permitted to be disclosed.)

**3.06** Permanently restricted net assets result from contributions whose use is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the organization's actions. Temporarily restricted net assets result from contributions whose use is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to these stipulations. Net assets may be temporarily restricted for various purposes, such as use in future periods or use for specified purposes.

**3.07** In the absence of donor-imposed restrictions, net assets should be classified as unrestricted. Paragraph 16 of FASB Statement No. 117 permits organizations to disclose self-imposed limitations on the use of unrestricted net

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[4] Assets other than cash may also be restricted by donors. For example, land could be restricted to use as a public park. Generally, however, restrictions apply to net assets, not to specific assets.

assets (such as board-designated endowments) in the notes to the financial statements or on their face, provided that total unrestricted net assets are displayed. Contractual limitations on the use of particular assets (such as cash held on deposit as a compensating balance) should be disclosed either on the face of the statement of financial position or in the notes to the financial statements.

## Statement of Activities

**3.08** A statement of activities should focus on the organization as a whole and should report the amount of the change in net assets for the period, using a descriptive term such as *change in net assets* or *change in equity*. The statement should report the amounts of the changes in permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and total net assets. Revenues, expenses, gains, and losses should be classified by net asset class.[5] Events that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items. Classification of revenues, expenses, gains, and losses and reclassifications are discussed in greater detail in subsequent chapters of this Guide.

**3.09** Paragraph 7 of FASB Statement No. 117 requires the display of an appropriately labeled subtotal within a statement of activities for the change in each class of net assets before the effects of extraordinary items, discontinued operations, or accounting changes. (Paragraph 7 of FASB Statement No. 117 also notes that not-for-profit organizations should apply the appropriate disclosure and display requirements for, among other things, unusual and infrequently occurring events.)

**3.10** The determination of the net asset class in which revenues, gains, and losses should be reported should be based solely on the presence or kind of donor-imposed restrictions. In the absence of such restrictions, revenues should be reported as increases in unrestricted net assets. All expenses should be reported as decreases in unrestricted net assets. Gains should be reported as increases, and losses as decreases, in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law. Expirations of donor-imposed restrictions that simultaneously increase one net asset class and decrease another (reclassifications) should be reported as separate items.

**3.11** FASB Statement No. 117 does not specify the way that revenues, expenses, gains, losses, and reclassifications should be sequenced. Paragraph 158 of FASB Statement No. 117 suggests several ways that items constituting those elements could be sequenced: (*a*) revenues and gains, reclassifications, expenses, and losses; (*b*) revenues, expenses, gains, losses, and reclassifications; and (*c*) certain revenues, less directly related expenses, followed by a subtotal, then other revenues, other expenses, gains and losses, and reclassifications. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses alternative ways of reporting costs related to sales of goods and services and the direct costs of special events.

**3.12** An organization may, if it wishes, incorporate additional classifications within the statement of activities. For example, it may classify revenues and expenses within a class or classes of net assets as operating and nonoperating, expendable and nonexpendable, recurring and nonrecurring, or in other ways, such as by business segments.

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[5] Paragraph 20 of FASB Statement No. 117 requires expenses to be reported as decreases in unrestricted net assets.

**3.13** Accordingly, an intermediate measure of operations, such as an excess or deficit of operating revenues over expenses, may be reported in a statement of activities, as long as the use of the term *operations* is clear either from the details provided on the face of the statement or from a description contained in a note to the financial statements. If an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in total unrestricted net assets for the period.

### Reporting Expenses

**3.14** To help users assess an organization's service efforts, including the costs of its services and how it uses resources, a statement of activities or the notes to the financial statements should report expenses by their functional classification, such as major programs and supporting activities. Voluntary health and welfare organizations[6] are required to report that information, together with information about expenses by their natural classification in a matrix format in a separate financial statement. A natural classification of expenses would include expense categories such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees. To the extent that those expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they should be reported by their natural classification if information about expenses by their natural classification is presented on the separate financial statement (matrix) containing natural classifications. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities should be included with other salaries, wages, and fringe benefits on the matrix containing natural classifications. FASB Statement No. 117 encourages, but does not require, other not-for-profit organizations to provide information about expenses by their natural expense classification.

## Statement of Cash Flows

**3.15** FASB Statement No. 117 amends FASB Statement No. 95, *Statement of Cash Flows*, by extending its provisions to not-for-profit organizations. A statement of cash flows provides relevant information about an organization's cash receipts and cash payments during a period; the statement classifies those receipts and payments as resulting from investing, financing, or operating activities. Separate disclosure of noncash investing and financing activities (for example, receiving contributions of buildings, securities, or recognized collection items) is also required.

**3.16** Operating activities are defined in FASB Statement No. 95 as including "all transactions and other events that are not defined as investing or financing activities" (paragraph 21). Cash flows from operating activities are not limited to the cash effects of transactions and other events that are reported on an organization's statement of activities and would include, if applicable, agency transactions.

**3.17** FASB Statement No. 95 permits entities to use either the direct or the indirect method of reporting cash flows from operating activities. The direct

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[6] *Voluntary health and welfare organizations* are defined in appendix D of FASB Statement No. 117. That definition includes a provision that "as a group, voluntary health and welfare organizations include those not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public..." For purposes of this Guide, the *general public* excludes governmental entities.

method reports major classes of gross cash receipts and gross cash payments from operating activities to arrive at a subtotal of net cash provided by or used in operating activities (net cash flow from operating activities). The direct method also requires a reconciliation of the change in (total) net assets to the net cash flow from operating activities in a separate schedule. The indirect method starts with the change in (total) net assets for the period and reconciles that amount to a subtotal of net cash flow from operating activities.

**3.18** FASB Statement No. 117 expands the description of financing activities in FASB Statement No. 95 to encompass receipts of resources that are donor-restricted for long-term purposes. As discussed in paragraph 3.03 of this Guide, cash that is received with donor-imposed restrictions limiting its use to long-term purposes should not be aggregated on a statement of financial position with cash that is available for current use. In order for the statement of cash flows to reconcile beginning and ending cash and cash equivalents, and to report in conformity with FASB Statement No. 95, as revised by FASB Statement No. 117, the receipt of a cash contribution that is restricted for the purchase of equipment should be reported as a cash flow from financing activities (using a caption such as "contributions restricted for purchasing equipment"), and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as "purchase of assets restricted to investment in property and equipment" or, if the equipment was purchased in the same period, "purchase of equipment").[7] An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as "cash or cash equivalents" on the statement of financial position. If the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the purchase of the equipment should be reported as cash flows from investing activities.

**3.19** Not all assets of not-for-profit organizations that meet the definition of *cash equivalents* in FASB Statement No. 95 are cash equivalents for purposes of preparing statements of financial position and cash flows. As noted in paragraph 3.03, restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment. Further, paragraph 10 of FASB Statement No. 95 states that an organization can, by policy, exclude from cash equivalents items that meet the definition of "cash equivalents." For example, an organization may hold a portion of its endowment portfolio in cash or other instruments with maturities of less than three months and exclude the cash and other instruments from "cash and cash equivalents." Similarly, cash and investments of endowment funds held temporarily until suitable long-term investments are identified may be excluded from cash equivalents. Paragraph 10 of FASB Statement No. 95 requires organizations to disclose their policy for determining which items are treated as cash equivalents.

## Comparative Financial Information

**3.20** Not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. Such

[7] Paragraphs 3.03 and 3.19 of this Guide discuss the classification on a statement of financial position of cash received with donor-imposed restrictions limiting its use to long-term purposes.

summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior-year information should be described by the use of appropriate titles on the face of the financial statements and in a note to the financial statements.[8, 9] The use of appropriate titles includes a phrase such as "with summarized financial information for the year ended June 30, 19PY," following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior-year summarized financial information "for comparative purposes only" without further disclosure in the notes to the financial statements would not constitute the use of an appropriate title.

**3.21** An example of a note to the financial statements[10] that describes the nature of the prior-period(s) information would be as follows:

> The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the organization's financial statements for the year ended June 30, 19PY, from which the summarized information was derived.

## Reporting of Related Entities

**3.22** In September 1994, the AICPA issued SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which is included as appendix B [paragraph 8.29] to chapter 8, "Investments," of this Guide.[11] SOP 94-3 amends and makes uniform the previously existing guidance concerning reporting related entities. The SOP is effective for financial statements issued for fiscal years beginning after December 31, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 31, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 prior to its effective date, earlier application of the SOP is encouraged. Comparative financial statements for earlier periods included with those for which the SOP is adopted should be restated.

**3.23** Some of the conclusions in SOP 94-3 depend on whether the reporting not-for-profit organization has an economic interest in other organizations. The Glossary of SOP 94-3 includes examples of economic interests. In addition to the examples included in the Glossary, the following is an example of an economic interest:

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[8] Chapter 14, "Reports of Independent Auditors," of this Guide, discusses auditors' reports on comparative financial information.

[9] Because the note discusses information that does not pertain to the current-period financial statements, the note is not considered to be part of the current-period financial statements.

[10] See footnote 9.

[11] The FASB currently has a project on its agenda on consolidations and related matters and has released an October 16, 1995, exposure draft, *Consolidated Financial Statements: Policy and Procedures*, in connection with that project. The conclusions in SOP 94-3 may be modified by a pronouncement resulting from that project.

The reporting entity has a right to or a responsibility for the operating results of another entity. Or upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity.

## Financial Statement Disclosures Not Considered Elsewhere

**3.24** Financial statement disclosures are generally discussed in this Guide in connection with the specific financial statement items to which they pertain. This section discusses disclosures that are unique to not-for-profit organizations and that are not discussed elsewhere in this Guide.

### Noncompliance With Donor-Imposed Restrictions[12]

**3.25** A not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

**3.26** FASB Statement No. 5, *Accounting for Contingencies*, provides guidance for accruing and disclosing contingent liabilities. Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), addresses disclosure of illegal acts that could lead to a material loss of revenue. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), contains broad guidance on disclosures when there is a substantial doubt about an entity's ability to continue as a going concern.

**3.27** Noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.[13] If the noncompliance results from an organization's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.

### Risks and Uncertainties

**3.28** SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires entities to include in their financial statements information about the following:

- The nature of their operations
- Use of estimates in the preparation of financial statements

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[12] As discussed in chapter 11, "Net Assets," of this Guide, and throughout other sections of this Guide, not-for-profit organizations should report amounts for each of three classes of net assets. Noncompliance with donor-imposed restrictions may result in net assets being reported other than in accordance with donor-imposed restrictions. For example, net assets would be reported other than in accordance with donor-imposed restrictions if restricted net assets were reported as unrestricted net assets. If net assets are reported other than in accordance with donor-imposed restrictions, the financial statements are not presented in conformity with GAAP.

[13] As discussed in paragraph 10.11, noncompliance with donor-imposed restrictions may require accrual of a liability in conformity with FASB Statement No. 5.

In addition, if specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about the following:

- Certain significant estimates
- Current vulnerability due to certain concentrations

The SOP includes examples of disclosures that may be pertinent for not-for-profit organizations. The provisions of the SOP are effective for financial statements issued for fiscal years ending after December 15, 1995.

# Chapter 4

# *Cash and Cash Equivalents*

## Introduction

**4.01** Like for-profit enterprises, not-for-profit organizations hold cash balances to meet payments arising in the ordinary course of operations and payments for unanticipated contingencies. These balances may be held as cash or cash equivalents.

**4.02** Cash includes currency on hand and deposits held by financial institutions that can be added to or withdrawn without limitation, such as demand deposits. Paragraph 8 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*, defines *cash equivalents* as "short-term, highly liquid investments that are both (*a*) readily convertible to known amounts of cash [and] (*b*) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates."[1] Not-for-profit organizations may invest excess cash in cash equivalents (such as treasury bills, commercial paper, and money-market mutual funds) to earn greater returns.

## Financial Statement Presentation

**4.03** A statement of financial position should include a separate line item, "Cash" or "Cash and Cash Equivalents." As noted in paragraph 3.03, cash and cash equivalents received with donor-imposed stipulations restricting the use of the cash contributed to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use.[2]

**4.04** Some limitations may exist on an organization's ability to withdraw or use cash and cash equivalents. These limitations may be imposed by (*a*) creditors and other outside parties (such as limitations on cash held by financial institutions to meet compensating balance requirements, cash and cash equivalents held as collateral on debt obligations, cash received as collateral on loaned securities, and cash held for students, clients, and others under agency agreements); (*b*) donors, who place permanent or temporary restrictions on their cash contributions (such as restricting the contributions to in-

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[1] Paragraph 8 of FASB Statement No. 95 indicates that, "...generally, only investments with original maturities [footnote reference omitted] of three months or less qualify under that definition."

[2] As noted in paragraph 3.04 of this Audit and Accounting Guide (Guide), paragraph 12 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires not-for-profit organizations to do one or more of the following: (*a*) sequence assets based on their nearness to cash, (*b*) classify assets as current and noncurrent, or (*c*) include relevant information about assets' liquidity, including restrictions on the use of particular assets, in notes to the financial statements. Paragraph 156 of Statement No. 117 illustrates this requirement: cash and cash equivalents restricted by donors to investment in fixed assets are not included as "cash or cash equivalents" but as "assets restricted to investment in land, buildings, and equipment"; cash and cash equivalents contributed by donors with stipulations that the contributed assets be invested permanently are reported as "long-term investments."

vestments in buildings or requiring that the principal be maintained permanently or for a specified time period); or (c) governing boards, which may designate cash for investment purposes (traditionally known as "funds functioning as endowment" or "quasi endowment").

**4.05** Relevant information about the nature and amount of limitations on the use of cash and cash equivalents should be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements.[3] (Chapter 11, "Net Assets," of this Guide, discusses accounting for net assets.) Disclosure in the notes to the financial statements should also be made if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the organization has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions.[4]

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[3] Paragraph 94 of FASB Statement No. 117 also permits not-for-profit organizations to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets.

[4] Paragraphs 3.25 through 3.27 of this Guide discuss reporting requirements when the organization is not in compliance with donor-imposed restrictions.

# Chapter 5

# *Contributions Received and Agency Transactions*

## Introduction

**5.01** Some not-for-profit organizations receive contributions of cash, other assets, and services from individuals, for-profit organizations, other not-for-profit organizations, and governments. Paragraph 5 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines a contribution as

> an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, services, and unconditional promises to give those items in the future.

**5.02** Some inflows of assets are not included in the definition of contributions, as follows:

- Transfers that are exchange transactions, in which both parties receive goods or services of commensurate value
- Transfers in which the organization is acting as an agent, trustee, or intermediary for the donor (that is, the organization has little or no discretion concerning the use of the assets transferred)[1]
- Tax exemptions, tax incentives, and tax abatements

This chapter provides guidance for distinguishing contributions from other kinds of transactions. It also discusses recognition, measurement, and disclosure principles for contribution revenues[2] and related receivables.[3] Chapter 12 of this Guide discusses accounting principles for revenues, gains, and receivables from providing services and from other exchange transactions. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses reporting contributions made by not-for-profit organizations.

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[1] On December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

[2] The classification of contributions received as revenues or gains depends on whether the transactions are part of the organization's ongoing major or central activities, or are peripheral or incidental to the organization. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation. Chapter 12, "Revenues and Receivables From Exchange Transactions," of this Audit and Accounting Guide (Guide), discusses the distinction between ongoing major activities and peripheral or incidental transactions and events.

[3] Unconditional promises to give cash or other financial instruments, such as an ownership interest in an entity, are *financial instruments* as defined in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk*, as amended by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments.*

## Distinguishing Contributions From Other Transactions[4]

**5.03** Contributions are transactions in which one entity, acting other than as an owner, makes an unconditional voluntary transfer to another entity without directly receiving equal value in exchange. Some resource providers may be required to transfer assets or provide services to not-for-profit organizations involuntarily; for example, to settle legal disputes or to pay fines. Those transactions are not contributions. Accounting for contributions is different from accounting for other kinds of voluntary transfers, such as conditional transfers, agency transactions, and exchange transactions. Accounting for transfers with donor-imposed conditions is discussed in paragraphs 5.23 through 5.25 of this Guide.

**5.04** To determine the accounting for transactions in which an entity voluntarily transfers assets to a not-for-profit organization, it is first necessary to assess the extent of discretion the not-for-profit organization has over the use of the assets that are received. If it has little or no discretion, the transaction is an agency transaction. If it has discretion over the assets' use, the transaction is a contribution, an exchange, or a combination of the two. Not-for-profit organizations should consider the guidance in paragraphs 52 through 54 of FASB Statement No. 116 in distinguishing contributions from agency transactions.[5]

**5.05** FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116),[6] clarifies that not-for-profit organizations that receive assets act as donees or donors, rather than as agents, trustees, or intermediaries, if the resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries. Such unilateral power is often referred to as *variance power*.

## Agency Transactions

**5.06** Resources received in transactions in which a not-for-profit organization is acting as an agent, trustee, or intermediary for a resource provider (that is, agency transactions) should be reported as increases in assets and liabilities; distributions to third-party recipients should be reported as decreases in those accounts.[7] Cash received and paid in such transactions should be reported as cash flows from operating activities in a statement of cash flows.

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[4] Federal rules specify the classification of certain transactions for purposes other than reporting in conformity with generally accepted accounting principles (GAAP), such as contractual reporting requirements. For example, certain transactions should be classified as federal awards received and expended by not-for-profit organizations. The guidance in this Guide pertains to financial reporting in conformity with GAAP. Classifications in conformity with GAAP may differ from classifications in accordance with federal rules.

[5] As discussed in footnote 1, on December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

[6] FASB Interpretation No. 42 was issued in September 1996 and is effective for financial statements issued for fiscal years ending after September 15, 1996, with earlier application encouraged. The Interpretation may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

[7] Chapter 6, "Split-Interest Agreements," of this Guide, discusses split-interest and similar agreements in which organizations act as trustee for a resource provider and have a beneficial interest in the assets transferred.

If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. Additional information about such transactions may be required to be disclosed under FASB Statement No. 57, *Related Party Disclosures*.

## *Gifts in Kind*

**5.07** Some not-for-profit organizations receive noncash assets—such as property, equipment, and inventory—from resource providers. Reporting these transfers, sometimes referred to as *gifts in kind*, as agency transactions or as contributions depends on the extent of discretion that the not-for-profit recipient has over the use or subsequent disposition of the assets. Information about gifts-in-kind transactions may be required to be disclosed under FASB Statement No. 57.

**5.08** Gifts in kind that can be used or sold should be measured at fair value.[8] In determining fair value, organizations should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the organization, including discounts based on that quantity if the assets had been acquired in exchange transactions. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized.

**5.09** Not-for-profit organizations may also receive items, such as tickets, gift certificates, works of art, and merchandise, that are to be used for fund-raising purposes by transferring them to other resource providers (the ultimate resource provider or recipient) during fund-raising events. The ultimate resource provider or recipient may acquire the items in transactions that are part exchange transactions and part contributions.[9] Such gifts in kind can be linked to asset transfers from the original resource providers to the ultimate resource providers (recipients) because they are, in substance, part of the same transaction; these gifts in kind should be reported as contributions and measured at fair value when originally received by a not-for-profit organization. The difference between the amount received for those items from the ultimate resource providers (recipients) and the fair value of the gifts in kind when originally contributed to the organization should be recognized as adjustments to the original contributions when the items are transferred to the ultimate resource providers (recipients). For example, a public radio station receives from the local community theater (the original resource provider) a ticket with a fair value of $75, to be auctioned to the highest bidder; a listener (the ultimate resource provider or recipient) subsequently acquires the ticket at auction for $100. The initial transfer of the ticket to the not-for-profit organization should be reported as a $75 contribution and the ticket should be reported as an asset; an additional $25 contribution should be reported when the ticket is transferred to the listener at auction, and no cost for the ticket should be reported on the statement of activities. If a listener acquires the ticket for $45, rather than $100, a reduction of $30 in contributions should be reported when the ticket is transferred to the listener at auction, because the transfer at auction is part of the transaction that was initiated when the organization received the

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[8] Fair value would generally not increase when a gift in kind is passed from one not-for-profit organization to another. However, fair value could increase if an organization adds value to the gift, such as by cleaning and packaging the gift. Any increases should be evaluated to determine whether the not-for-profit organization did, in fact, add to the fair value of the assets.

[9] Paragraphs 13.17 through 13.22 of this Guide discuss reporting special events associated with an organization's fund-raising efforts.

ticket. Holding the ticket from the time of initial receipt to the time of ultimate transfer at auction does not create a transaction separate from the initial contribution.

## Exchange Transactions

**5.10** Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. In some situations, exchange transactions can be easily distinguished from contributions. For example, purchases of assets or payments of employees' salaries clearly are exchange transactions: each party gives up and receives equivalent economic value. In contrast, an example of a contribution is a donation to a not-for-profit organization's mass fund-raising appeal: donors are providing resources in support of the organization's mission and expect to receive nothing of direct value in exchange.

**5.11** The cost of premiums (such as postcards or calendars) given to potential donors as part of mass fund-raising appeals is a fund-raising expense, and the classification of the donations received from the appeal as contributions is unaffected by the fact that premiums were given to potential donors. The premiums are not provided to potential donors in exchange for the assets contributed; they can be kept by all those from whom funds are solicited, regardless of whether a contribution is made.

**5.12** The cost of premiums (such as coffee mugs) that are given to resource providers to acknowledge receipt of a contribution and that are nominal in value compared with the value of the goods or services donated by the resource provider should also be reported as fund-raising expenses.[10] For example, a not-for-profit organization may provide a coffee mug to people making a contribution of $50 or more; the mug costs the organization $1. The organization should recognize contributions for the total amount contributed and fund-raising expense of $1 for each mug provided to donors.

**5.13** Classifying asset transfers as exchange transactions or as contributions may require the exercise of judgment concerning whether a reciprocal transaction has occurred, that is, whether a recipient not-for-profit organization has given up assets, rights, or privileges approximately equal to the value of the assets, rights, or privileges received. Value should be assessed from both the recipient's and the resource provider's points of view and can be affected by a wide variety of factors; for example, resource providers can retain the right to share in the use of or income from an asset provided to the not-for-profit organization.

**5.14** Table 5.1 contains a list of indicators that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Several kinds of voluntary asset transfers that may be difficult to classify are discussed in the following four paragraphs.

**5.15** Some not-for-profit organizations receive dues from their members. These transfers often have elements of both a contribution and an exchange transaction because members receive tangible or intangible benefits from their

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[10] Donors may receive premiums that are greater than nominal in value in connection with some transactions. Such transactions should be reported as part exchange transaction and part contribution. The cost of premiums that are greater than nominal in value should be reported as cost of sales. Chapter 12 of this Guide provides guidance concerning reporting exchange transactions.

membership in the organization. For example, if an organization has annual dues of $100 and the only benefit members receive is a monthly newsletter with a fair value of $25, $25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and $75 of the dues are a contribution. It may be difficult, however, to measure the benefits members receive and to determine whether the value of those benefits is approximately equal to the dues paid by the members. Table 5.2 contains a list of indicators that may be helpful in determining whether membership dues are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

Table 5.1

## Indicators Useful in Distinguishing Contributions From Exchange Transactions

| *Indicator* | *Contribution* | *Exchange Transaction* |
|---|---|---|
| Recipient not-for-profit organization's (NPO's) intent in soliciting the asset* | Recipient NPO asserts that it is soliciting the asset as a contribution. | Recipient NPO asserts that it is seeking resources in exchange for specified benefits. |
| Resource provider's expressed intent about the purpose of the asset to be provided by recipient NPO | Resource provider asserts that it is making a donation to support the NPO's programs. | Resource provider asserts that it is transferring resources in exchange for specified benefits. |
| Method of delivery | The time or place of delivery of the asset to be provided by the recipient NPO to third-party recipients is at the discretion of the NPO. | The method of delivery of the asset to be provided by the recipient NPO to third-party recipients is specified by the resource provider. |
| Method of determining amount of payment | The resource provider determines the amount of the payment. | Payment by the resource provider equals the value of the assets to be provided by the recipient NPO, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided. |
| Penalties assessed if NPO fails to make timely delivery of assets | Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NPO is not penalized for nonperformance.) | Provisions for economic penalties exist beyond the amount of payment. (The NPO is penalized for nonperformance.) |
| Delivery of assets to be provided by the recipient NPO | Assets are to be delivered to individuals or organizations other than the resource provider. | Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider. |

* This table refers to assets. Assets may include services. The terms assets and services are used interchangeably in this table.

Table 5.2

## Indicators Useful for Determining the Contribution and Exchange Portions of Membership Dues

| *Indicator* | *Contribution* | *Exchange Transaction* |
|---|---|---|
| Recipient NPO's expressed intent concerning purpose of dues payment | The request describes the dues as being used to provide benefits to the general public or to the NPO's service beneficiaries. | The request describes the dues as providing economic benefits to members or to other organizations or individuals designated by or related to the members. |
| Extent of benefits to members | The benefits to members are negligible. | The substantive benefits to members (for example, publications, admissions, educational programs, and special events) may be available to nonmembers for a fee. |
| NPO's service efforts | The NPO provides service to members and nonmembers. | The NPO benefits are provided only to members. |
| Duration of benefits | The duration is not specified. | The benefits are provided for a defined period; additional payment of dues is required to extend benefits. |
| Expressed agreement concerning refundability of the payment | The payment is not refundable to the resource provider. | The payment is fully or partially refundable if the resource provider withdraws from membership. |
| Qualifications for membership | Membership is available to the general public. | Membership is available only to individuals who meet certain criteria (for example, requirements to pursue a specific career or to live in a certain area). |

**5.16** Revenue derived from membership dues in exchange transactions should be recognized over the period to which the dues relate. Nonrefundable initiation and life membership fees received in exchange transactions should be recognized as revenues in the period in which the fees become receivable if future fees are expected to cover the costs of future services to be provided to members. If nonrefundable initiation and life membership fees, rather than future fees, are expected to cover those costs, nonrefundable initiation and life member fees received in exchange transactions should be recognized as revenue over the average duration of membership, the life expectancy of members, or other appropriate time periods.

**5.17** Foundations, business organizations, and other types of entities may provide resources to not-for-profit organizations under programs referred to as *grants*, *awards*, or *sponsorships*.[11] Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource providers is incidental to the potential public benefit from using the assets transferred. The asset transfers are exchange transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. For example, a grant made by a resource provider to a not-for-profit organization would likely be a contribution if the activity specified by the grant is to be planned and carried out by the not-for-profit organization and the organization has the right to the benefits of carrying out the activity. If, however, the grant is made by a resource provider that provides materials to be tested in the activity and that retains the right to any patents or other results of the activity, the grant would likely be an exchange transaction.

**5.18** Some transfers of assets between not-for-profit organizations and governments (such as the sale of goods and services) are exchange transactions. Other transfers of assets between not-for-profit organizations and governments (such as unrestricted support given by state and local governments) are contributions. Other kinds of government transfers (sometimes referred to as *grants*, *awards*, or *appropriations*) have unique characteristics that may make it difficult to determine whether they are contributions or exchange transactions. The indicators described in Table 5.1 provide guidance on how to classify such transfers. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

**5.19** As discussed in paragraphs 5.26 through 5.34 and in chapters 3, "Basic Financial Statements," and 11, "Net Assets," of this Guide, classification of net assets and revenues as either unrestricted, temporarily restricted, or permanently restricted depends on the existence or absence of donor-imposed restrictions on contributions. Therefore, resources received in exchange transactions should be classified as unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources. For example, resources received from governments in exchange transactions in which those governments have placed limitations on the use of the resources should be reported as unrestricted revenues and net assets, because those limitations are not donor-imposed restrictions on contributions.

## Recognition Principles for Contributions

**5.20** Accounting for contributions depends on whether the transfer of assets, including promises to give, is received by the not-for-profit organization

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[11] Such resource transfers may also have the characteristics of agency transactions. Paragraphs 5.04 and 5.06 discuss agency transactions.

with donor-imposed conditions, donor-imposed restrictions, or both. A donor-imposed condition specifies a future and uncertain event (for example, a stipulation that the organization must meet a matching requirement) whose occurrence or failure to occur gives the donor the right of return of the assets or releases the donor from the obligation to transfer assets in the future. A promise that contains a condition is considered to be unconditional if the possibility that the condition will not be met is remote.[12] For example, a promise that is conditioned on the not-for-profit organization meeting administrative requirements, such as the filing of an annual financial report, should not be considered conditional if the likelihood of not meeting the administrative requirements is remote. A donor-imposed restriction is a stipulation specifying a use for a contribution that is more specific than the broad limits resulting from the nature and purpose of the organization and from the environment in which it operates.

**5.21** Distinguishing between a condition stipulated by a donor and a restriction on the use of a contribution imposed by a donor may require the exercise of judgment. Because of the uncertainty about whether they will be met, conditions imposed by resource providers may cast doubt on whether the resource provider's intent was to make a contribution, to make a conditional contribution, or to make no contribution. As a result of this uncertainty, donor-imposed conditions should be substantially met by the organization before the receipt of assets (including contributions receivable) is recognized as a contribution. In contrast to donor-imposed conditions, donor-imposed restrictions limit the use of the contribution, but they do not change the transaction's fundamental nature from that of a contribution.

**5.22** Determining whether a promise is conditional or unconditional can be difficult if the promise contains donor stipulations that do not state clearly whether the right to receive payment or delivery of the promised assets depends on meeting those stipulations. It may be difficult to determine whether those stipulations are conditions or restrictions. In cases of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional should be presumed to be a conditional promise.

## Donor-Imposed Conditions

**5.23** A transfer of assets with a conditional promise to contribute them should be accounted for as a refundable advance until the conditions have been substantially met or the conditions have been explicitly waived by the donor. (Transfers of assets, including promises to give, on which resource providers have imposed conditions should be recognized as contributions if the likelihood of not meeting the conditions is remote.)

**5.24** Some conditions attached to contributions may be substantially met in stages rather than because of a single event. A portion of those contributions should be recognized as revenue as each of those stages is met. For example, a resource provider promises to contribute $1 for each $1 of contributions received by a not-for-profit organization, up to $100,000, over the next six months. As contributions are received from other resource providers, the conditions would be met and the promise would become unconditional. For example, if $10,000 is received in the first month from donors, $10,000 of the conditional promise would become unconditional and should be recognized as

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[12] Paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, defines an event to be *remote* when "the chance of the future event or events occurring is slight."

contribution revenue. Contributions, such as certain contributions made by governments, that are conditioned upon the organization incurring certain qualifying costs, should be recognized as revenue as those costs are incurred.

**5.25** Unconditional contributions should be recognized as revenue in the period received.[13] Depending on the kind of benefit received, the organization should also recognize (*a*) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized, see chapter 7, "Other Assets," of this Guide], and property and equipment); (*b*) a decrease in liabilities (for example, accounts payable or notes payable); or (*c*) an expense (for example, donated legal services).

## Donor-Imposed Restrictions

**5.26** Contributions may be received with donor-imposed restrictions. Some restrictions permanently limit the organization's use of contributed assets. Other restrictions are temporary in nature, limiting the organization's use of contributed assets to (*a*) later periods or after specific dates (time restrictions), (*b*) specific purposes (purpose restrictions), or (*c*) both.

**5.27** Restrictions may (*a*) be stipulated explicitly by the donor in a written or oral communication accompanying the contribution or (*b*) result implicitly from the circumstances surrounding receipt of the contributed asset—for example, making a gift to a capital campaign whose stated objective is to raise funds for a new building. Contributions of unconditional promises to give with payments due in future periods should be reported as temporarily restricted contributions unless the donor expressly stipulates, or circumstances surrounding the receipt of the promise make clear, that the donor intended it to be used to support activities of the current period.

**5.28** Donors can impose restrictions on otherwise unrestricted net assets, as well as on their own contributions. For example, a donor may make a restricted contribution that is conditioned on the not-for-profit organization restricting a stated amount of its unrestricted net assets. Such restrictions that are not reversible without donors' consent result in a reclassification of unrestricted net assets to restricted net assets.

**5.29** Unconditional contributions received without donor-imposed restrictions should be reported as unrestricted support that increases unrestricted net assets. Unconditional contributions received with donor-imposed restrictions should be reported as restricted support that increases permanently restricted or temporarily restricted net assets, depending on the nature of the restriction.[14] The permanently restricted classification should be used if the limits imposed on the use of the contributed assets are permanent (for example, contributions of cash or securities that must be invested in perpetuity to provide a permanent source of income for the organization or contributions of permanently restricted collection items or of cash that must be used to purchase permanently restricted collection items). The temporarily restricted classification should be used for contributions if the limitations are temporary

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[13] Unconditional contributions of services and collection items are subject to different recognition criteria. Paragraphs 5.40, 5.41, and 7.06 discuss those transactions.

[14] A subsequent event may arise that raises the possibility that the organization may not satisfy a donor-imposed restriction. Statement on Auditing Standards (SAS) No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), provides guidance on the recognition and disclosure of subsequent events.

(for example, a restriction that contributed assets may be used only after some future date, or for some specific program, or to acquire a specific asset).

**5.30** In some situations, an organization may meet donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period in which the contribution is received. In those cases, the contribution (to the extent that the restrictions have been met) may be reported as unrestricted support that increases unrestricted net assets provided that the organization has a similar policy for reporting investment gains and income,[15] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

**5.31** The expiration of donor-imposed restrictions on contributions should be reported in the period or periods in which (*a*) a donor-stipulated time has elapsed (for example, the restriction on a term endowment in which contributed cash is to be invested for ten years expires at the end of the tenth year) or (*b*) a donor-stipulated purpose for which the contribution was restricted has been fulfilled by the organization (for example, the restriction on a contribution to acquire operating supplies expires when those supplies are acquired by the organization). If two or more donor-imposed restrictions are stipulated by the donor, the expiration of the restriction should be reported in the period in which the last remaining restriction is satisfied. Expirations of donor-imposed restrictions should be reported in a statement of activities as reclassifications, decreasing temporarily restricted net assets and increasing unrestricted net assets.

**5.32** Expenses may be incurred for purposes for which both unrestricted and temporarily restricted net assets are available. If an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue. For example, an employee's salary may meet donor-imposed restrictions to support the program on which the employee is working. In that situation, the restriction is met to the extent of the salary expense incurred unless incurring the salary will lead to inflows of revenues from a specific external source, such as revenues from a cost reimbursement contract or a conditional promise to give that becomes unconditional when the organization incurs the salary expense.

**5.33** Not-for-profit organizations may receive contributions of long-lived assets (such as property and equipment) or of cash and other assets restricted to the purchase of long-lived assets, for which donors have not expressly stipulated how or how long the long-lived asset must be used by the organization or how to use any proceeds resulting from the asset's disposal. An organization may adopt an accounting policy of implying time restrictions on the use of such contributed assets that expire over the assets' expected useful lives. If an organization adopts such a policy, the contributions received should be reported as restricted support that increases temporarily restricted net assets. Depreciation should be recorded over the asset's useful life, and net assets should be reclassified periodically from temporarily restricted to unrestricted as depreciation is recognized. Long-lived assets that are subject to an accounting policy implying time restrictions on the use of contributed long-lived assets

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[15] Paragraph 8.17 discusses the accounting policy for reporting investment gains and income if the organization meets donor-imposed restrictions on all or a portion of such gains and income in the same reporting period as the gains and income are recognized.

may be disposed of before the end of their useful lives. In those situations, the gains and losses on the disposal of those assets should be reported as changes in unrestricted net assets and a reclassification should be reported for any remaining temporarily restricted net assets.

**5.34** Other organizations may adopt a policy of not implying time restrictions on contributions of long-lived assets (or of other assets restricted to the purchase of long-lived assets) received without donor stipulations about how long the contributed assets must be used. If an organization adopts such a policy, contributions of long-lived assets with no donor-imposed time restrictions should be reported as unrestricted support. Contributions of cash and other assets restricted to the acquisition of long-lived assets should be reported as restricted support that increases temporarily restricted net assets; those restrictions expire when the long-lived assets are placed in service by the organization.

## Promises to Give

**5.35** Not-for-profit organizations may enter into written or oral agreements with donors involving future nonreciprocal transfers of cash, other assets, and services.[16] Such agreements between not-for-profit organizations and potential donors should be reported as contribution revenue and receivables if such agreements are, in substance, unconditional promises to give,[17] even if the promise is not legally enforceable.

**5.36** Conditional promises to give cash or other assets (such as securities or property and equipment) should be recognized as contribution revenue and receivables when the conditions are substantially met. Unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received.[18] Depending on the existence and nature of donor-imposed restrictions, unconditional promises to give should be reported either as unrestricted support that increases unrestricted net assets, or as restricted support that increases permanently restricted or temporarily restricted net assets. Use of the *permanently restricted* classification is appropriate if donor-imposed restrictions stipulate that the resources must be maintained permanently (for example, donors' promises to give cash or securities that must be invested in perpetuity). Use of the temporarily restricted classification is appropriate if donor-imposed restrictions (*a*) expire by passage of time or (*b*) can be fulfilled or removed by actions of the organization pursuant to donor stipulations.

**5.37** Unconditional promises to give that are due in future periods and are not permanently restricted generally increase temporarily restricted net assets, rather than unrestricted net assets. If, however, the donor explicitly stipulates that the promise to give is to support current-period activities or if other circumstances surrounding the promise make it clear that the donor's in-

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[16] Paragraph 70 of FASB Statement No. 116 notes that "promises to give services generally involve personal services that, if not explicitly conditional, are often implicitly conditioned upon the future and uncertain availability of specific individuals whose services have been promised." It is assumed in the remainder of this chapter that promises to give services are conditional and, hence, not recognized until the services are performed.

[17] Paragraph 6 of FASB Statement No. 116 defines *promise to give* as "a written or oral agreement to contribute cash or other assets to another entity." These items are sometimes referred to as *pledges*, a term that FASB Statement No. 116 and this Guide avoid because it may be misinterpreted. Paragraphs 5.04 and 5.06 discuss agency transactions.

[18] If a contribution is transferred to the ultimate recipient through an agent, the ultimate recipient should recognize the contribution when sufficient verifiable evidence that the agent has received the promise to give or other assets becomes available.

tention is to support current-period activities, unconditional promises to give should be reported as unrestricted support that increases unrestricted net assets.

**5.38** Before a promise to give can be recognized, sufficient verifiable evidence should exist documenting that a promise was made by the donor and received by the not-for-profit organization. Such evidence may be included in written or verifiable oral communications, including (*a*) written agreements, (*b*) pledge cards, and (*c*) oral promises documented by tape recordings, written contemporaneous registers, follow-up written confirmations, and other means that permit subsequent verification of the oral communications. A communication that does not indicate clearly whether it is a promise is considered an unconditional promise to give if it indicates an unconditional intention to give that is legally enforceable. Promises to give that do not discuss the specific time or place for the contribution but that are otherwise clearly unconditional in nature should be considered unconditional promises to give.

**5.39** Not-for-profit organizations may receive communications that are intentions to give, rather than promises to give. For example, communications from individuals indicating that the organization has been included in the individual's will as a beneficiary are intentions to give. Such communications are not unconditional promises to give, because individuals retain the ability to modify their wills during their lifetimes. (When the probate court declares the will valid, the not-for-profit organization should recognize contribution revenue and a receivable at the fair value of its interest in the estate, unless the promise is conditioned upon future or uncertain events, in which case a contribution should not be recognized until the conditions are substantially met. Not-for-profit organizations should disclose information about conditional promises in valid wills in conformity with paragraph 25 of FASB Statement No. 116.) Solicitations for donations that clearly include wording such as "information to be used for budget purposes only" or that clearly and explicitly allow resource providers to rescind their indications that they will give are intentions to give rather than promises to give and should not be reported as contributions.

## Contributed Services

**5.40** Contributed services should be reported as contribution revenue and as assets or expenses only if the services create or enhance a nonfinancial (that is, nonmonetary) asset (for example, property and equipment) or—

- Would typically need to be purchased by the organization if they had not been provided by contribution,
- Require specialized skills, and
- Are provided by individuals with those skills (such as accounting, financial, construction, educational, electrical, legal, medical, and other services provided by accountants, investment advisers, contractors, teachers, electricians, lawyers, doctors, and other professionals and craftspeople).

If such contributions are reported, they should be measured at fair value.[19] Examples of situations in which it may be appropriate to recognize contributed services are included in paragraphs 195 to 206 of FASB Statement No. 116.

**5.41** Contributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated organizations regu-

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[19] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the services at their fair value.

larly perform services (in other than an advisory capacity) for and under the direction of the recipient organization and the recognition criteria for contributed services are met.

## Contributed Utilities and Use of Long-Lived Assets

**5.42** Not-for-profit organizations may receive unconditional contributions of the use of electric, telephone, and other utilities and of long-lived assets (such as a building or the use of facilities) in which the donor retains legal title to the long-lived asset. Organizations receiving such contributions should recognize contribution revenue in the period in which the contribution[20] is received and expenses in the period the utilities or long-lived assets are used.[21] If the transaction is an unconditional promise to give (as described in paragraphs 5.35 through 5.39) for a specified number of periods, the promise should be reported as contributions receivable and as restricted support that increases temporarily restricted net assets.[22]

**5.43** Unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title to the long-lived asset may be received in connection with leases or may be similar to leases but have no lease payments. For example, not-for-profit organizations may use facilities under lease agreements that call for lease payments at amounts below the fair rental value of the property. In such circumstances, the not-for-profit organization should report a contribution for the difference between the fair rental value of the property and the stated amount of the lease payments.[23] (However, amounts reported as contributions should not exceed the fair value of the long-lived asset at the time the organization receives the unconditional promise to give.) The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable.

## Contributed Collection Items

**5.44** Not-for-profit organizations may receive contributions of works of art, historical treasures, and similar items that meet the definition of collections in paragraph 11 of FASB Statement No. 116. The recognition and measurement principles for contributions of collections depend on the collections-capitalization policy adopted by the organization. Accounting for collections is discussed in chapter 7 of this Guide.

## Split-Interest Agreements

**5.45** A split-interest agreement is a form of contribution in which a not-for-profit organization receives benefits that are shared with other beneficiaries designated by the donor. Common kinds of such agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Because of the specialized nature of these arrangements, they are discussed separately in chapter 6 of this Guide.

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[20] As discussed in paragraph 5.01, contributions include both the use of facilities and utilities, as well as promises to give those items in the future.

[21] Whether such contributions should be reported is unaffected by whether the not-for-profit organization could afford to purchase the utilities or facilities at their fair value.

[22] Paragraphs 5.46 through 5.54 discuss measurement principles for initial recognition of contributions received.

[23] See footnote 20.

## Measurement Principles for Contributions

**5.46** Contribution revenue should be measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. (Contributions arising from unconditional promises to give that are expected to be collected within one year of the financial statement date may be measured at their net realizable value.) Fair value can best be measured by quoted market prices. If such prices are not available, fair value can be estimated based on one of the following:

- Quoted market prices for similar assets
- The asset's replacement cost
- Independent appraisals of the asset's fair value
- Other valuation techniques, such as discounting the estimated future cash flows

The fair value of contributed services that create or enhance nonfinancial assets should be estimated based on (*a*) the fair value of the services received or (*b*) the fair value of the assets created (or the change in the fair value of the asset that is being enhanced), whichever is more readily determinable.

**5.47** Major uncertainties about the existence of value of a contributed asset may indicate that a contribution should not be recognized. Such uncertainties are often present when an item has no use other than for scientific or educational research or for its historical significance. Examples of such items include flora, fauna, photographs, and objects identified with historic persons, places, or events.

**5.48** If a promise to give has not previously been recognized as contribution revenue because it was conditional, fair value should be measured when the conditions are met.

**5.49** The fair value of contributions arising from unconditional promises to give cash should be determined based on the present value of the estimated future cash flows. Exhibit 5.1 below illustrates initial recognition of unconditional promises to give cash that are expected to be collected one year or more after the financial statement date.

**Exhibit 5.1**

**Initial Recognition of Unconditional Promises to Give Cash**

*Facts*

Assume that a not-for-profit organization receives a promise (or promises from a group of homogeneous donors) to give $100 in five years, that the estimated future cash flows from the promise(s) are $70, and that the present value of the estimated future cash flows is $50.

*Solution*

| | | | |
|---|---|---|---|
| dr. | Contributions Receivable | $70 | |
| cr. | Contribution Revenue—Temporarily Restricted | | $50 |
| cr. | Discount on Contributions Receivable | | $20 |

(To report contributions receivable and revenue for the present value of the estimated future cash flows.)

[*Note to Readers*: Some organizations may use a subsidiary ledger to retain information concerning the $100 face amount of contributions promised in order to monitor collections of contributions promised.]

**5.50** The fair value of contributions arising from unconditional promises to give noncash assets should be determined based on the present value of the expected fair value of the underlying noncash assets expected to be received at the date those assets are expected to be received,[24] if the date is one year or more after the financial statement date. (Both the (*a*) likelihood of the promise being fulfilled[25] and (*b*) expected fair value of those underlying assets, such as the expected fair value per share of a promised equity security, should be considered in determining the expected fair value of the underlying noncash assets expected to be received.) In some cases, the expected fair value of the underlying asset may be difficult to determine. In those cases, the fair value of the underlying asset at the date of initial recognition may be the best estimate of the present value of the expected fair value of the underlying asset. (No discount should be reported if an asset's fair value at the date of initial recognition is used to estimate the present value of the expected fair value of the underlying asset.)

**5.51** In determining the estimated future cash flows of unconditional promises to give cash (or, for promises to give noncash assets, the quantity and nature of assets expected to be received), not-for-profit organizations should consider when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, and other factors concerning the receivable's collectibility.

## Discounting

**5.52** The present value of unconditional promises to give should be measured using a risk-free rate of return appropriate for the expected term of the promise to give. (A risk-free rate of return, rather than the donor's borrowing rate, is the discount rate commensurate with the risks involved because, as discussed in paragraph 5.51, the donor's credit rating and other factors affecting the donor's ability to honor the promise to give would be considered in determining the estimated future cash flows of unconditional promises to give cash [or, for promises to give noncash assets, the quantity and nature of assets expected to be received]. Therefore, the amount to be discounted is considered to be free from credit risk.) In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.

**5.53** Discounts on contributions receivable that are measured at present value should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are received. In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize the discount. Other methods of amortization may be used if the results are not materially different. The amount of the periodic amortization of the discount should be included as a component of contribution

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[24] Throughout the remainder of this chapter, the phrase *the expected fair value of the underlying asset* [or *underlying security,* or *underlying noncash asset*] is used to refer to the expected fair value of the underlying asset [or underlying security, or underlying noncash asset] at the date the asset [or security, or noncash asset] is expected to be received.

[25] The quantity, nature, and timing of assets expected to be received, such as the number of shares of a promised equity security, the company in which those shares represent an equity interest, and when those shares will be received should be considered in determining the likelihood of the promise being fulfilled.

revenue and should be reported as an increase in permanently restricted, temporarily restricted, or unrestricted net assets, depending on the net asset class in which the promise was originally reported.

**5.54** Contributions receivable should be reported net of the discount that arises when measuring a promise to give at present value. The discount should be separately disclosed by reporting it as a deduction from contributions receivable either on the face of a statement of financial position or in the notes to the financial statements.

## Subsequent Measurement

**5.55** The fair value of contributions arising from unconditional promises to give cash and noncash assets may change because of (*a*) changes in the quantity or nature of assets expected to be received (such as changes in the amounts of future cash flows), (*b*) changes in the timing of assets expected to be received,[26] and (*c*) changes in the expected fair value of underlying noncash assets.

### *Changes in the Quantity or Nature of Assets Expected to Be Received*

**5.56** If the fair value of contributions arising from unconditional promises to give cash or noncash assets decreases because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized in the period(s) in which the expectation changes. Such decreases should be reported as expenses or losses (bad debt) in the net asset class in which the net assets are represented.[27] No increase in net assets should be recognized if the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received between the date the unconditional promises to give are recognized and the date they are collected, except as provided in the next sentence. If the fair value of contributions arising from unconditional promises to give increases because of changes in the quantity or nature of assets expected to be received, and previous decreases in the fair value of those promises have resulted in expenses or losses from bad debts, such increases should be reported as recoveries of those expenses or losses, to the extent that those expenses or losses have been recognized, in the net asset classes in which the net assets are represented. Amounts collected, other than recoveries of bad debt expenses or losses, in excess of the carrying amount of contributions receivable should be reported as contribution revenue in the appropriate net asset class.

### *Changes in the Fair Value of Underlying Noncash Assets*

**5.57** As discussed in paragraph 5.55, the fair value of contributions arising from unconditional promises to give noncash assets may change because of changes in the expected fair value of the underlying noncash assets. If, in a period subsequent to initial measurement, an observed change in the

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[26] The FASB's Present-Value-Based Measurements project is addressing questions about accounting measurements based on the present value of future inflows and outflows of cash and other assets (interest methods). Accordingly, this Guide does not address accounting for changes in the timing of assets expected to be received.

[27] As discussed in chapters 3 and 13 of this Guide, all expenses should be reported as decreases in unrestricted net assets. Therefore, decreases in contributions because of changes in the amounts of assets expected to be received should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

current fair value of the asset to be contributed occurs, that change in fair value may or may not result in changes in the expected fair value of the underlying noncash asset, depending on the method and assumptions used for determining the expected fair value of the underlying noncash asset. For purposes of subsequent measurement, the method for determining the expected fair value of the underlying noncash asset should be the same as the method used for determining that amount for purposes of initial measurement. (Paragraph 5.50 discusses the measurement principles for initial recognition of unconditional promises to give noncash assets, including consideration of the expected fair value of the underlying asset.) Accordingly, assumed relationships, such as the relationship between the market price of the noncash asset at the time the initial measurement is made and its projected market price at the date the asset is expected to be received, should be presumed to continue in determining whether the expected fair value of the underlying noncash asset has changed. (As discussed in paragraph 5.50, the fair value of the underlying noncash asset at the date of initial recognition may be the best estimate of the present value of the expected fair value of the underlying noncash asset. If that method is used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed should be treated as if they were changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the expected fair value of the underlying asset. If that method is not used at initial measurement, for subsequent measurement, observed changes in the current fair value of the asset to be contributed may or may not result in changes in the expected fair value of the underlying asset, and, therefore, may or may not result in changes in the fair value of contributions arising from unconditional promises to give noncash assets because of changes in the expected fair value of the underlying asset.)

**5.58** Paragraph 5.59 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities because of changes in the expected fair value of the underlying securities. Paragraph 5.60 discusses accounting for changes in the fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities because of changes in the expected fair value of the underlying noncash assets.

**5.59** The fair value of contributions arising from unconditional promises to give equity securities with readily determinable fair values or debt securities may change between the date the unconditional promise to give is recognized and the date the asset promised is received because of changes in the expected fair value of the underlying securities. Such changes should be reported as increases and decreases in contribution revenue in the period(s) in which the change occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented.

**5.60** The fair value of contributions arising from unconditional promises to give noncash assets other than equity securities with readily determinable fair values or debt securities may decrease between the date the unconditional promise to give is recognized and the date the asset promised is received because of decreases in the expected fair value of the underlying noncash assets. Such decreases should be reported as decreases in contribution revenue in the period(s) in which the decrease occurs, in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented. No additional revenue should be recognized if the expected fair value of those underlying noncash assets increases between the date the unconditional promise to give is recognized and the date the asset promised is received.

### Illustration

**5.61** Table 5.3 below illustrates the accounting for changes in the fair value of contributions subsequent to initial recognition but before collection.

**Table 5.3**

## Accounting for Changes in Fair Value of Contributions (Subsequent to Initial Recognition But Before Collection)

| | *Reason for the Change in Fair Value* | | | |
|---|---|---|---|---|
| *Underlying Asset* | *Change in Collectibility of the Receivable* | | *Change in the Expected Fair Value of the Underlying Asset* | |
| | *Increase in Fair Value* | *Decrease in Fair Value* | *Increase in Expected Fair Value* | *Decrease in Expected Fair Value* |
| Cash | No adjustment* | Recognize expense or loss (bad debt) | Not applicable | Not applicable |
| FASB No. 124 securities** | No adjustment* | Recognize expense or loss (bad debt) | Recognize additional contribution revenue | Recognize a decrease in contribution revenue |
| Other assets | No adjustment* | Recognize expense or loss (bad debt) | No adjustment | Recognize a decrease in contribution revenue |

* Recoveries of previously recognized decreases in fair value resulting from changes in estimates of collectibility (up to the amount of decreases previously recognized), however, should be recognized as reductions of bad debt expense or loss.

** For purposes of this table, *FASB No. 124 securities* are defined as equity securities with readily determinable fair values and all debt securities.

## Financial Statement Presentation

**5.62** *Contribution revenue* may be reported as a separate line item on a statement of activities. However, this does not preclude reporting separate line items for government contracts, membership dues,[28] special events, or similar revenue sources in other revenue categories or in the notes to the financial statements.

[28] Accounting for the portion of membership dues that is an exchange transaction is different than accounting for the portion that is a contribution. Paragraphs 5.15 and 5.16 discuss revenue recognition principles for membership dues.

**5.63** The notes to the financial statements should also include the following:

- The accounting policies adopted by the organization concerning the following:
  - — Whether the organization implies time restrictions on the use of contributed long-lived assets (and contributions of cash and other assets restricted to purchasing them) received without donor stipulations about how long the contributed assets must be used (Paragraphs 5.33 and 5.34 provide guidance concerning the application of this policy.)
  - — Whether the organization classifies donor-restricted contributions as unrestricted or restricted support if restrictions are satisfied in the same reporting period in which the contributions are received (Paragraph 5.30 provides guidance concerning the application of this policy.)
  - — Whether the organization recognizes contributions of collection items (Paragraphs 7.05 through 7.09 provide guidance concerning the application of this policy.)
- Disclosures relating to the liquidity of the organization's contributions receivable, including the following:
  - — Contributions receivable pledged as collateral or otherwise limited as to use
  - — A schedule of unconditional promises to give (showing the total amount separated into amounts receivable in less than one year, in one to five years, and in more than five years) and the related allowance for uncollectible promises receivable arising from subsequent decreases due to changes in the quantity or nature of assets expected to be received (see paragraph 5.56), and the unamortized discount[29]
  - — The amount of conditional promises to give—in total and, with descriptions, the amount of each group of similar promises (for example, those conditioned upon the development of new programs, upon the purchase or construction of new property and equipment, and upon the raising of matching funds within a specified time period)
- Disclosures required by APB Opinion No. 21

**5.64** The notes to the financial statements should include the following disclosures concerning contributions of services received during the period:

- The nature and extent of contributed services received by the organization
- A description of the programs or activities for which the services were used
- The amount of contributed services recognized during the period

Not-for-profit organizations are encouraged to report in the notes to the financial statements, if practical, the fair value of contributed services received but not recognized.

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[29] The amount of unconditional promises to give included in the schedule represents amounts reported as contributions receivable. For example, assume that, on the last day of its fiscal year, an organization receives promises to give $100 in five years, that the estimated future cash flows from the promises are $70, and that the present value of the estimated future cash flows is $50. The notes to the financial statements should disclose unconditional promises to give of $70 and unamortized discount of $20.

## Illustrative Disclosures

**5.65** The following section provides examples of notes to financial statements that illustrate some of the disclosures discussed in this chapter.

### Example 1—Donor-Imposed Restrictions

Note X: Summary of Significant Accounting Policies

All contributions are considered to be available for unrestricted use unless specifically restricted by the donor. Amounts received that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support that increases those net asset classes. However, if a restriction is fulfilled in the same time period in which the contribution is received, the organization reports the support as unrestricted.

### Example 2—Promises to Give

Note X: Summary of Significant Accounting Policies

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on those amounts are computed using risk-free interest rates applicable to the years in which the promises are received. Amortization of the discounts is included in contribution revenue. Conditional promises to give are not included as support until the conditions are substantially met.

Note Y: Promises to Give

Included in "Contributions Receivable" are the following unconditional promises to give:

| | *19X1* | *19X0* |
|---|---|---|
| Capital campaign | $1,220 | |
| Restricted to future periods | 795 | $530 |
| Unconditional promises to give before unamortized discount and allowance for uncollectibles | 2,015 | 530 |
| Less: Unamortized discount | (180) | (24) |
| Subtotal | 1,835 | 506 |
| Less: Allowance for uncollectibles | (150) | (30) |
| Net unconditional promises to give | $1,685 | $476 |
| Amounts due in: | | |
| Less than one year | $1,220 | |
| One to five years | 725 | |
| More than five years | 70 | |
| Total | $2,015 | |

Discount rates ranged from 4 percent to 4.5 percent and from 3.5 percent to 4 percent for 19X1 and 19X0, respectively.

In 19X0, the organization received $650 for a capital campaign which must be returned if the organization does not receive $1,300 in donations to the capital campaign. The $650 received was recorded on the 19X0 statement of financial position as a refundable advance. In 19X1, the organization received $500 in cash donations and $865 in unconditional promises to give to this campaign. As a result, the $650 was recognized as temporarily restricted contributions in 19X1.

In addition, the organization received the following conditional promises to give that are not recognized as assets in the statements of financial position:

| | *19X1* | *19X0* |
|---|---|---|
| Conditional promise to give upon the establishment of a library program | $ 100 | $100 |
| Conditional promise to give upon obtaining $2,500 in unconditional promises to give to the capital campaign | 5,000 | |

[*The following disclosure is encouraged but not required.*]

The organization received an indication of an intention to give from an individual long-time donor. The anticipated gift is an extensive collection of pre-Columbian textiles with great historical and artistic significance. The value of this intended gift has not been established, nor has the gift been recognized as an asset or contribution revenue.

## Example 3—Accounting Policy for Contributed Property and Equipment

Note X: Summary of Significant Accounting Policies

Contributed property and equipment is recorded at fair value at the date of donation. In the absence of donor stipulations regarding how long the contributed assets must be used, the organization has adopted a policy of implying a time restriction on contributions of such assets that expires over the assets' useful lives. As a result, all contributions of property and equipment, and of assets contributed to acquire property and equipment, are recorded as restricted support.

*OR*

Contributed property and equipment is recorded at fair value at the date of donation. If donors stipulate how long the assets must be used, the contributions are recorded as restricted support. In the absence of such stipulations, contributions of property and equipment are recorded as unrestricted support.

## Example 4—Contributed Services

The organization recognizes contribution revenue for certain services received at the fair value of those services. Those services include the following items:

| | *19X1* | *19X0* |
|---|---|---|
| Home outreach program: | | |
| Salaries: | | |
| Social work interns—261 and 315 hours at $12.00 per hour | $ 3,132 | $ 3,780 |
| Registered nurse—200 and 220 hours at $15.00 per hour | 3,000 | 3,300 |
| Total salaries | 6,132 | 7,080 |
| Management and general: | | |
| Accounting services | 10,000 | 19,000 |
| Total contributed services | $16,132 | $26,080 |

In addition, approximately 80,000 hours, for which no value has been assigned, were volunteered by tutors in the home outreach program.

## Auditing

**5.66** Since for-profit organizations do not usually receive contributions or enter into agency transactions, the specific audit objectives, selected controls, and auditing procedures related to contributions, contributions receivable, and agency transactions are unique to not-for-profit organizations and are presented below.

**5.67** Not-for-profit organizations that receive significant amounts of contributions should have an accounting system, along with controls built into that system, for recording the receipt and collection of contributions. Internal control should also provide reasonable assurance that revenues arising from conditional promises to give are recognized when the conditions have been substantially met and that restrictions on contributions are recognized in the appropriate net asset class. The absence of such an accounting system and related controls might make it difficult for the auditor to obtain the necessary assurance about the completeness assertion and the presentation and disclosure assertion for contribution revenues and receivables and net assets. Accordingly, the auditor's assessment of control risk with respect to assertions related to contribution revenues and receivables may constitute a major activity in the planning process.

**5.68** Paragraph 34 of SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), states that "confirmation of accounts receivable is a generally accepted auditing procedure," and that there is a presumption that the auditor will request the confirmation of accounts receivable except under certain specified circumstances. That paragraph defines *accounts receivable* as "(*a*) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and (*b*) a financial institution's loans." Though under that definition contributions receivable are not accounts receivable to which that presumption would apply, the auditor may nevertheless decide to request confirmation of contributions receivable.

**5.69** Receivables are usually confirmed principally to provide evidence about the existence/occurrence assertion. FASB Statement No. 116 specifies that for a promise to give to be recognized in financial statements, there must be sufficient evidence in the form of verifiable documentation that a promise was received. If the documentation is not present, an asset should not be recognized. The verifiable documentation required by Statement No. 116 for recognition of promises to give may not be sufficient evidence concerning the existence/occurrence assertion. Confirming recorded promises to give (contributions receivable) may provide additional evidence about the existence of promises to give, the existence or absence of restrictions, the existence or absence of conditions, and the periods over which the promises to give become due. If the auditor confirms promises to give, he or she should follow the guidance in SAS No. 67 concerning the confirmation process.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Contribution Revenues and Receivables* | | | |
| Existence/ occurrence | Amounts recognized as contribution revenues and related receivables represent valid unconditional contributions and promises to give. | Controls ensure that only unconditional contributions and promises to give are recognized in the financial statements. | Examine documentation supporting recognition of contribution revenues and promises to give, including information such as absence of conditions and the periods over which the promises to give become due. |
| Completeness | All unconditional contributions and promises to give are recognized. | Controls ensure that all unconditional contributions and promises to give are recognized in the financial statements. Controls ensure that conditional promises to give are recognized when the conditions have been substantially met. | Compare detailed receivables from promises to give with data accumulated and maintained by the fund-raising function and investigate reconciling items. |
| Valuation | Contribution revenues and related receivables are appropriately valued. | Controls ensure the appropriate valuation of contribution revenue and promises to give at the time of initial recognition. | Review and test the methods used to measure contribution revenue and promises to give at the time of initial recognition. |
| | | The valuation of promises to give is periodically | Review promises to give for collectibility and, |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | reviewed by management. | if appropriate, changes in fair value of the underlying asset. |
| | | Writeoffs of uncollectible promises to give are identified and approved in accordance with the entity's established policy. | |
| Presentation and Disclosure | Restricted contributions are reported in the proper net asset class. | Contributions are reviewed for restrictions and other limitations. | Review the documentation underlying contributions and promises to give (including donor correspondence and governing board minutes) for propriety of classification. |
| | Disclosures related to contributions are proper. | | Determine the appropriateness of disclosures for conditional and unconditional promises to give. |
| *Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets* | | | |
| Existence/ occurrence; completeness; valuation; presentation and disclosure | Assets, expenses, and revenues from contributed services, utilities, facilities, and use of long-lived assets meet the appropriate recognition criteria; all such contributions that meet the recognition criteria are recognized and | Controls ensure that only contributed services, utilities, facilities, and use of long-lived assets that meet the appropriate recognition criteria are recognized; controls ensure that all such contributions that meet the | Review the documentation underlying recognition of contributed services, utilities, facilities, and use of long-lived assets for completeness and propriety of amounts recognized, presented, and disclosed. |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | appropriately measured, presented, and disclosed. | recognition criteria are recognized and appropriately measured, presented, and disclosed. | |
| *Agency Transactions* | | | |
| Existence/ occurrence; completeness | Assets and liabilities from agency transactions meet the criteria for classification and recognition as agency transactions. | Controls ensure that (1) only resources received and paid in agency transactions are classified and recognized as agency transactions and (2) all such transactions are recognized. | Review the documentation underlying the receipt of assets from resource providers that will be transferred to others for propriety of classification and recognition. |
| | All agency transactions are recognized. | | Review the documentation underlying the distribution of assets to others for propriety of classification and recognition. |
| | | | Review the historical patterns of the distribution of gifts in kind and other assets to determine the extent of the organization's discretion over those distributions. |

# Chapter 6

# *Split-Interest Agreements*[1]

## Introduction

**6.01** Some donors enter into trust or other arrangements under which not-for-profit organizations receive benefits that are shared with other beneficiaries. Recognition and measurement principles for these arrangements, commonly known as *split-interest agreements*, are discussed in this chapter. The application of these principles to five widely used types of such agreements—charitable lead trusts, perpetual trusts held by third parties,[2] charitable remainder trusts, charitable gift annuities, and pooled (life) income funds—is also illustrated.

## Types of Split-Interest Agreements

**6.02** Under a split-interest agreement, a donor makes an initial gift to a trust or directly to the not-for-profit organization, in which the not-for-profit organization has a beneficial interest but is not the sole beneficiary. The terms of some agreements do not allow donors to revoke their gifts; other agreements may be revocable by donors in certain situations. The time period covered by the agreement is expressed either as a specific number of years (or in perpetuity) or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. At the end of the agreement's term, the remaining assets covered by the agreement are distributed to or retained by either the not-for-profit organization or another beneficiary or beneficiaries.

**6.03** Under some kinds of agreements, referred to in this Audit and Accounting Guide (Guide) as *lead interests*, the not-for-profit organization receives the distributions during the agreement's term. In other kinds of agreements, referred to as *remainder interests*, the donor (or other individuals or organizations designated by the donor) receives those distributions and the not-for-profit organization receives all or a portion of the assets remaining at the end of the agreement's term. Under either kind of agreement, donors may impose restrictions on the not-for-profit organization's use of all or a portion of any assets received.

## Recognition and Measurement Principles

**6.04** Not-for-profit organizations should report irrevocable split-interest agreements. Assets received under those agreements should be recorded at

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[1] The Financial Accounting Standards Board (FASB) currently has a project on its agenda on consolidations and related matters and has released an October 16, 1995, exposure draft, *Consolidated Financial Statements: Policy and Procedures*, in connection with that project. That project may modify the conclusions in this Guide.

[2] Though perpetual trusts held by third parties may not meet the definition of a split-interest agreement because the not-for-profit organization may be the sole beneficiary, they are included in this chapter because they present some of the same accounting issues as do split-interest agreements.

their fair value when received.[3] Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8, "Investments," of this Guide. The contribution portion of an agreement (that is, the part that represents the unconditional transfer of assets in a voluntary nonreciprocal transaction) should be recognized as revenue or gain.[4] Liabilities incurred in the exchange portion of an agreement (usually an agreement to pay an annuity to the donor) should also be recognized.

**6.05** In the absence of donor-imposed conditions, not-for-profit organizations should recognize contribution revenue and related assets and liabilities when irrevocable split-interest agreements naming them trustee or fiscal agent are executed. If an unrelated third party (for example, a bank, trust company, or private individual) acts as trustee or fiscal agent, a contribution should be recognized when the not-for-profit organization is notified of the agreement's existence. If the third party has substantive discretion over to whom benefits are distributed, the agreement should be considered an intention to give by the not-for-profit organization.[5] Contribution revenue should not be recognized under such agreements until the organization has an unconditional right to receive benefits under the agreement.

## Recognition of Revocable Agreements

**6.06** Revocable split-interest agreements should be accounted for as intentions to give. Assets received by not-for-profit organizations acting as a trustee under revocable split-interest agreements should be recognized at fair value when received and as refundable advances. (Contribution revenue for the assets received should be recognized when the agreements become irrevocable or when the assets are distributed to the not-for-profit organization for its unconditional use, whichever occurs first.) Assets held under such agreements as investments should be reported in conformity with the guidance in chapter 8. Income earned on assets held under such agreements that is not available for the organization's unconditional use, and any subsequent adjustments to the carrying value of those assets, should be recognized as adjustments to the assets and as refundable advances.

## Initial Recognition of Unconditional Irrevocable Agreements

**6.07** At the date of initial recognition of a split-interest agreement, contributions should be measured at fair value. Under a lead interest agreement, the fair value of the contribution can be estimated directly based on the present value of the estimated future distributions expected to be received by the not-

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[3] Some split interest agreements include promises to give noncash assets, such as homes. Paragraph 5.50 of this Guide includes guidance concerning determining the fair value of unconditional promises to give noncash assets.

[4] As discussed in footnote 2 to chapter 5, "Contributions Received and Agency Transactions," of this Guide, contributions may be reported as revenues or gains, depending on whether they are part of the organization's ongoing major activities or are peripheral or incidental transactions. For purposes of this chapter, the term *contribution revenue* is used to apply to either situation.

[5] If the third party is a not-for-profit organization, it may have received the resources as a contribution or as an agency transaction. Paragraphs 52 through 54 of FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, include guidance concerning distinguishing contributions from agency transactions. On December 29, 1995, the FASB released an exposure draft of a proposed Interpretation, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary (An Interpretation of FASB Statement No. 116)*. That exposure draft addresses various issues concerning transactions in which a not-for-profit organization acts as an agent, trustee, or intermediary as those terms are used in FASB Statement No. 116.

for-profit organization as a beneficiary. Under a remainder interest agreement, future distributions will be received by the not-for-profit organization only after obligations to other beneficiaries are satisfied. In those cases, the fair value of the contribution may be estimated based on the fair value of the assets contributed by the donor less the present value of the payments expected to be made to other beneficiaries. Any method for measuring the fair value of the contribution must consider (*a*) the estimated return on the invested assets during the expected term of the agreement, (*b*) the contractual payment obligations under the agreement, and (*c*) a discount rate commensurate with the risks involved.[6] In conformity with paragraph 12 of Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the contribution is initially recognized and should not be revised subsequently.

**6.08** Contribution revenues recognized under split-interest agreements should be classified as increases in temporarily restricted net assets unless the donor has permanently restricted the organization's use of its interest (lead or remainder) in the assets or the donor gives the organization the immediate right to use without restrictions the assets it receives.[7] If the donor has permanently restricted the organization's use of its interest, the contribution should be classified as an increase in permanently restricted net assets. If the organization has the immediate right to use its interest without restrictions, the contribution should be classified as increases in unrestricted net assets.

**6.09** When a not-for-profit organization serves as trustee or when the assets contributed by the donor are otherwise under the control of the not-for-profit organization, cash and other assets received under split-interest agreements should be recognized at fair value at the date of initial recognition. If those assets, or a portion of those assets, are being held for the benefit of others, such as the donor or third parties designated by the donor, a liability, measured at the present value of the expected future payments to be made to other beneficiaries, should also be recognized at the date of initial recognition.[8] In some cases, such as under remainder interest agreements, the present value of the expected future payments to be made to other beneficiaries can be estimated directly based on the terms of the agreement. In other cases, such as under lead interest agreements, the future payments will be made by the not-for-profit organization only after the organization receives its benefits. In those situations, the present value of the future payments to be made to other beneficiaries may be estimated by the fair value of the assets contributed by the donor under the agreement less the present value of the estimated benefits to be received by the not-for-profit organization.

**6.10** In arrangements in which cash or other assets contributed by donors under split-interest agreements are held by independent trustees or by other

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[6] Reference to Internal Revenue Service (IRS) guidelines and actuarial tables used in calculating the donor's charitable deduction for income tax purposes may be helpful in assessing the reasonableness of the method used for measuring fair value.

[7] Under many charitable gift annuity agreements, the assets received from the donor are held by the not-for-profit organization as part of its general assets and are available for its unrestricted use.

[8] Additional annuity reserves may be required by the laws of the state where the not-for-profit organization is located or by the state where the donor resides. Legally mandated reserves should be disclosed in the notes to the financial statements. In addition, some not-for-profit organizations voluntarily set aside additional reserves as a cushion against unexpected actuarial losses. Voluntary reserves should be included as part of unrestricted net assets, but may be disclosed as a separate component, such as board-designated unrestricted net assets (see chapter 11, "Net Assets," of this Guide).

fiscal agents of the donors or are otherwise not controlled by the not-for-profit organization, the not-for-profit organization should recognize its beneficial interest in those assets. Contribution revenue and a receivable should be measured at the present value of the estimated future distributions expected to be received by the organization over the expected term of the agreement.

### Recognition During the Agreement's Term

**6.11** During the term of the agreement, the following transactions and events should be recognized as "changes in the value of split-interest agreements" in a statement of activities and classified as temporarily restricted, permanently restricted, or unrestricted net assets, depending on the classification used when the contribution revenue was recognized initially: (*a*) amortization of the discount associated with the contribution and (*b*) revaluations of expected future payments to beneficiaries, based on changes in life expectancy, and other actuarial assumptions.[9]

**6.12** When assets held in trust and related liabilities are recognized under lead and remainder interest agreements for which a not-for-profit organization serves as a trustee or fiscal agent, income earned on those assets, gains and losses, and distributions made to other beneficiaries under the agreements should be reported in the organization's statements of financial position, activities, and cash flows.

**6.13** Amounts should be reclassified from temporarily restricted net assets to unrestricted net assets as distributions are received by not-for-profit organizations under the terms of split-interest agreements, unless those assets are otherwise temporarily restricted by the donor. In that case, they should be reclassified to unrestricted net assets when the restrictions expire.

### Recognition Upon Termination of Agreement

**6.14** Upon termination of a split-interest agreement, asset and liability accounts related to the agreement should be closed. Any remaining amounts in the asset or liability accounts should be recognized as changes in the value of split-interest agreements and classified as changes in permanently restricted, temporarily restricted, or unrestricted net assets, as appropriate. If assets previously distributed to the not-for-profit organization become available for its unrestricted use upon termination of the agreement, appropriate amounts should be reclassified from temporarily restricted to unrestricted net assets.

## Financial Statement Presentation

**6.15** Assets and liabilities recognized under split-interest agreements should be disclosed separately from other assets and liabilities in a statement of financial position or in the related notes. Contribution revenue and changes in the value of split-interest agreements recognized under such agreements should also be disclosed as separate line items in a statement of activities or in the related notes. The notes to the financial statements should include the following disclosures related to split-interest agreements:

- A description of the general terms of existing split-interest agreements

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[9] As discussed in paragraph 5.52, the discount rate should not be revised subsequent to initial recognition.

- The basis used (for example, cost, lower of cost or market, fair market value) for recognized assets
- The discount rates and actuarial assumptions used in calculating present values

## Examples of Split-Interest Agreements

**6.16** Many kinds of split-interest agreements have been developed. The examples in this section demonstrate how the recognition and measurement principles discussed in this chapter apply to some common kinds of agreements. The appendix [paragraph 6.39] to this chapter provides journal entries related to these examples.

### Charitable Lead Trust

**6.17** A charitable lead trust is an arrangement in which a donor establishes and funds a trust with specific distributions to be made to a designated not-for-profit organization over a specified period. The organization's use of the assets distributed may be restricted by the donor. The distributions may be for a fixed dollar amount, an arrangement called a charitable lead annuity trust (CLAT), or for a fixed percentage of the trust's fair market value as determined annually, a charitable lead unitrust (CLUT). Upon termination of the trust, the remainder of the trust assets is paid to the donor or to the beneficiaries designated by the donor.

**6.18** For example, not-for-profit organization A receives cash from a donor under an irrevocable charitable lead annuity trust agreement designating the organization as trustee and lead beneficiary. Under the terms of the trust, organization A will invest the assets and receive a specified dollar amount each year for its unrestricted use until the death of the donor. At that time, the remaining assets in the trust revert to the donor's estate.

**6.19** Contribution revenue, assets held in trust, and a liability for amounts held for others should be recognized by organization A in the period in which the trust is established. Revenue should be reported as temporarily restricted support and measured at the present value of the specified dollar amount to be received annually over the expected life of the donor. The assets held in trust by organization A should be recorded at fair value at the date of initial recognition. The difference between the fair value of the assets received and the contribution revenue represents the present value of the liability to pay the donor's estate upon the termination of the trust.

**6.20** In subsequent periods, both the income earned on the trust assets and recognized gains and losses should be reflected in the trust asset and liability accounts. Adjustments of the liability to reflect amortization of the discount and revaluations of the future cash flows based on revisions in the donor's life expectancy should be recognized as changes in the value of split-interest agreements and classified as changes in temporarily restricted net assets in a statement of activities. Amounts should be reclassified from temporarily restricted to unrestricted net assets as the annual distributions to organization A are made and recognized during the term of the trust. Upon the death of the donor, the assets are distributed to the donor's estate, the asset and liability accounts are closed, and any difference between the balances in those accounts should be recognized as a change in the value of split-interest agreements in the temporarily restricted net asset class.

**6.21** If organization A is not the trustee and does not exercise control over the trust's assets, it should recognize its beneficial interest in those assets as temporarily restricted contribution revenue and as a receivable, measured at the present value of the expected future cash inflows. Distributions from the trust should be reflected as a reduction in the receivable and as reclassifications from temporarily restricted net assets to unrestricted net assets. Amortization of the discount and revaluations of expected future cash flows based on revisions in the donor's life expectancy should be recognized as adjustments to the receivable and as changes in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class. Any balance in the receivable account remaining upon termination of the trust should be recognized as a change in the value of split-interest agreements in the statement of activities in the temporarily restricted net asset class.

## Perpetual Trust Held by a Third Party

**6.22** A perpetual trust held by a third party is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or organization other than the not-for-profit beneficiary. Under the terms of the trust, the not-for-profit organization has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust. Distributions received by the organization may be restricted by the donor.

**6.23** For example, a donor establishes a trust with the donor's bank serving as trustee. Funds contributed to the trust are to be invested in perpetuity. Under the terms of the trust, not-for-profit organization B is to be the sole beneficiary and is to receive annually the income on the trust's assets as earned in perpetuity. Organization B can use the distributions from the trust in any way that is consistent with its mission.

**6.24** The arrangement should be recognized by organization B as contribution revenue and as an asset when the organization is notified of the trust's existence. The fair value of the contribution should be measured at the present value of the estimated future cash receipts from the trust's assets.[10] The contribution should be classified as permanently restricted support, because the trust is similar to donor restricted permanent endowment that the organization does not control, rather than a multiyear promise to give. Annual distributions from the trust are reported as investment income that increase unrestricted net assets. Adjustments to the amount reported as an asset, based on an annual review using the same basis as was used to measure the asset initially, should be recognized as permanently restricted gains or losses.

## Charitable Remainder Trust

**6.25** A charitable remainder trust is an arrangement in which a donor establishes and funds a trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust. The not-for-profit organization may ultimately have unrestricted use of those assets, or the donor may place permanent or temporary restrictions on

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[10] That value may generally be measured by the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows.

their use. The distributions to the beneficiaries may be for a specified dollar amount, an arrangement called a charitable remainder annuity trust (CRAT), or for a specified percentage of the trust's fair market value as determined annually, a charitable remainder unitrust (CRUT). Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

**6.26** For example, a donor establishes a charitable remainder unitrust, with not-for-profit organization C serving as trustee. Under the trust's terms, the donor's spouse is to receive an annual distribution equal in value to a specified percentage of the fair market value of the trust's assets each year until the spouse dies. The income earned on the trust's assets must remain in the trust until the spouse dies. At that time, the remaining assets of the trust are to be distributed to organization C for use as a permanent endowment.

**6.27** Organization C should recognize the contribution in the period in which the trust is established. The assets held in trust by organization C should be recorded at fair value when received, and the liability to the donor's spouse should be recorded at the present value of the estimated future payments to be distributed over the spouse's expected life. The amount of the contribution is the difference between these amounts and should be classified as permanently restricted support.

**6.28** In subsequent periods, income earned on trust assets, recognized gains and losses, and distributions paid to the spouse should be reflected in the organization's statement of financial position. Adjustments to the liability to reflect amortization of the discount, revaluations of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions should be recognized in a statement of activities as a change in the value of split-interest agreements in the permanently restricted net asset class. Upon the death of the spouse, the liability should be closed and any balance should be recognized as a change in the value of split-interest agreements in the statement of activities in the permanently restricted net asset class.

**6.29** If organization C is not the trustee and does not exercise control over the assets contributed to the trust, the agreement should be recognized as an unconditional promise to give. Organization C should recognize, as permanently restricted contribution revenue and as a receivable, the present value of the estimated future benefits to be received when the trust assets are distributed. Adjustments to the receivable to reflect amortization of the discount, revaluation of the present value of the estimated future payments to the spouse, and changes in actuarial assumptions during the term of the trust should be recognized as changes in the value of split-interest agreements. Upon the death of the spouse, the receivable is closed, the assets received from the trust are recognized at fair value, and any difference is reported as a change in the value of split-interest agreements in permanently restricted net assets.

## Charitable Gift Annuity

**6.30** A charitable gift annuity is an arrangement between a donor and a not-for-profit organization in which the donor contributes assets to the organization in exchange for a promise by the organization to pay a fixed amount for a specified period of time to the donor or to individuals or organizations designated by the donor. The agreements are similar to charitable remainder annuity trusts except that no trust exists, the assets received are held as general assets of the not-for-profit organization, and the annuity liability is a general obligation of the organization.

**6.31** For example, not-for-profit organization D and a donor enter into an arrangement whereby assets are transferred from the donor to organization D. Organization D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies.

**6.32** Organization D should recognize the agreement in the period in which the contract is executed. The assets received should be recognized at fair value when received, and an annuity payment liability should be recognized at the present value of future cash flows expected to be paid to the donor's spouse. Unrestricted[11] contribution revenue should be recognized as the difference between these two amounts.

**6.33** In subsequent periods, payments to the donor's spouse reduce the annuity liability. Adjustments to the annuity liability to reflect amortization of the discount and changes in the life expectancy of the donor's spouse should be recognized in a statement of activities as changes in the value of split-interest agreements in unrestricted net assets. Upon the death of the donor's spouse, the annuity liability should be closed and a change in the value of split-interest agreements should be recognized in the statement of activities.

## Pooled (Life) Income Fund

**6.34** Some not-for-profit organizations form, invest, and manage pooled (or life) income funds.[12] These funds are divided into units, and contributions of many donors' life income gifts are pooled and invested as a group. Donors are assigned a specific number of units based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. Until a donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units. Upon the donor's death, the value of these assigned units reverts to the not-for-profit organization.

**6.35** For example, a donor contributes assets to not-for-profit organization E's pooled (life) income fund and is assigned a specific number of units in the pool. The donor is to receive a life interest in any income earned on those units. Upon the donor's death, the value of the units is available to organization E for its unrestricted use.

**6.36** Organization E should recognize its remainder interest in the assets received as temporarily restricted contribution revenue in the period in which

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[11] The contribution portion of a charitable gift annuity agreement should be recognized as unrestricted support if both (*a*) the donor does not restrict the use of the assets contributed to the organization and (*b*) neither the agreement nor state law requires the assets received by the not-for-profit organization to be invested until the income beneficiary's death. If either of these situations exists, the contribution should be classified as restricted and should be reclassified if temporary restrictions or legal requirements are satisfied. If neither of these situations exist but state law imposes other limitations on the organization, such as limitations on the manner in which some net assets are invested, such limitations should be disclosed in the notes to the financial statements.

[12] Net income unitrusts are similar to pooled life-income funds, because the corpus is maintained. Accordingly, financial reporting for net income unitrusts is similar to reporting for pooled life-income funds.

the assets are received from the donor. The contribution should be measured at the fair value of the assets to be received, discounted for the estimated time period until the donor's death. The contributed assets should be recognized at fair value when received. The difference between the fair value of the assets when received and the revenue recognized should be recorded as deferred revenue, representing the amount of the discount for future interest.

**6.37** Periodic income on the fund and payments to the donor should be reflected as increases and decreases in a liability to the donor. Amortization of the discount should be recognized as a reduction in the deferred revenue account and as a change in the value of split-interest agreements and reported as a change in temporarily restricted net assets. Upon the donor's death, any remaining balance in the deferred revenue account should be closed and a change in the value of split-interest agreements should be recognized. A reclassification to unrestricted net assets is also necessary to record the satisfaction of the time restriction on temporarily restricted net assets.

## Auditing

**6.38** Since for-profit organizations do not usually enter into split-interest agreements, the specific audit objectives, selected controls, and auditing procedures related to such agreements are unique to not-for-profit organizations and are presented below. See also the discussion concerning confirming receivables in paragraphs 5.68 and 5.69 of chapter 5 of this Guide.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| Existence/ occurrence | Amounts recognized as (1) contribution revenues, (2) cash, investments, contributions receivable, and other assets held in trust under split-interest agreements, and (3) liabilities for amounts held for others resulting from split-interest agreements represent valid revenues, assets, and liabilities. | Management authorizes split-interest agreements. | Review split-interest agreements and correspondence with donors or trustees. |
| Completeness | All unconditional split-interest agreements are recognized.<br><br>All income received under split-interest agreements is recorded. | Controls ensure that split-interest agreements are known and recorded.<br><br>Management reviews income distribution terms of split-interest agreements and determines that periodic reports and remittances from trustees conform to those terms. | Review minutes of governing board and governing board committee meetings for evidence of split-interest agreements.<br><br>Compare income distribution terms of split-interest agreements to periodic reports and remittances from trustees; trace periodic reports and remittances from trustees to cash receipts records. |
| Valuation | Assets and revenues recognized at the inception of | Documentation supports the determination of assets, liabilities, | Review documentation, including reports of actuaries, |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | split-interest agreements are measured at fair value when received, and liabilities for amounts held for others are recognized at the present value of the payments expected to be made to other beneficiaries, using appropriate measurement methods. | revenues, and changes in the value of split-interest agreements, both at the inception of the agreements and over their term. | supporting the determination of fair value of assets and revenues and the present value of payments expected to be made to other beneficiaries at the inception of split-interest agreements and over their term; consider the need to apply provisions of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), in conjunction with auditing the actuarial calculations. |
| | Amortization of the discount associated with the contribution and revaluations of expected future payments to beneficiaries based on changes in actuarial assumptions are recognized during the term of split-interest agreements. | | |
| Rights and obligations; presentation and disclosure | Restrictions on contributions arising from split-interest agreements have been met. | Split-interest agreements are reviewed for restrictions. | Review split-interest agreements and donor correspondence. |
| | Contribution revenues recognized under split-interest agreements are reported in the proper net asset class. | | Determine that appropriate reclassifications are made on the statement of activities as assets are distributed to the organization or as |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | Contribution revenues and changes in net assets from amortization of the discount associated with the contribution and revaluations of expected future payments to beneficiaries based on changes in actuarial assumptions that are recognized during the term of split-interest agreements are reported in the proper net asset class. | | restrictions otherwise expire. |
| | Temporarily restricted net assets are reclassified as unrestricted net assets as assets are distributed to the not-for-profit organization or as restrictions otherwise expire. | | |

6.39

## Appendix—Journal Entries

**1.** This appendix provides journal entries related to the examples in paragraphs 6.16 through 6.37.

**2.** ***Charitable Lead Trust (not-for-profit organization is trustee)*** (paragraphs 6.17 through 6.20)

Not-for-profit organization (NPO) A enters into an irrevocable charitable lead annuity trust arrangement with a donor whereby:

- The donor establishes a trust, with NPO A serving as trustee.
- The terms of the trust are that NPO A is to receive an annuity of $X per year until the donor's death.
- Distributions received from the trust by NPO A are unrestricted.
- Upon the death of the donor, the remaining balance in the trust passes to the donor's estate.

<u>Solution:</u>

Creation of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

cr. Contribution Revenue—Temporarily Restricted

(Assets measured at fair value when received; revenue measured at present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Assets Held in Charitable Lead Trust

cr. Liability for Amounts Held for Others

(Trust income and changes in fair value of assets held in trust, to the extent recognized)

dr. Cash

cr. Assets Held in Charitable Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amounts received by NPO)

dr. Liability for Amounts Held for Others

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and revaluation based on changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability for Amounts Held for Others

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted (or cr.)

cr. Assets Held in Charitable Lead Trust

(Return of assets to donor's estate)

3. ***Charitable Lead Trust (NPO is not trustee)*** (paragraph 6.21)

The fact situation is the same as in the previous example except that the NPO is not the trustee.

Solution:

Creation of the trust:

dr. Contributions Receivable from Lead Trust

cr. Contribution Revenue—Temporarily Restricted

(Beneficial interest in trust assets measured at the present value of cash flows to be received by NPO over the expected life of the donor)

Over the term of the trust:

dr. Cash

cr. Contributions Receivable from Lead Trust

(Distribution of income to NPO)

dr. Temporarily Restricted Net Assets—Reclassifications Out

cr. Unrestricted Net Assets—Reclassifications In

(Reclassification of amount received by NPO)

dr. Contributions Receivable from Lead Trust

cr. Change in Value of Split-Interest Agreements —Temporarily Restricted

(Amortization of discount and changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Change in Value of Split-Interest Agreements—Temporarily Restricted

cr. Contributions Receivable from Lead Trust

(Closeout receivable)

4. ***Perpetual Trust Held by a Third Party*** (paragraphs 6.22 through 6.24)

Donor enters into an irrevocable perpetual trust agreement with a third-party trustee with NPO B as the income beneficiary whereby:

- The donor establishes a trust, with its bank serving as trustee, with a payment to the trust to be invested in perpetuity by the trustee.
- The terms of the trust are that NPO B is to be the sole beneficiary and receive the income on the trust assets as earned in perpetuity with no restrictions on its use.

*Solution:*

Creation of the trust:

dr. Beneficial Interest in Perpetual Trust

cr. Contribution Revenue—Permanently Restricted

(Assets and revenue measured at present value based on the expected future cash flows to NPO [generally measured by the fair value of assets contributed to the trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows])

Each period:

dr. Cash

cr. Investment Income (Unrestricted)

(Income received from trust [net asset class based on stipulations of the trust])

dr. Beneficial Interest in Perpetual Trust

cr. Gain or Loss—Permanently Restricted

(To adjust asset for changes in present value of expected cash flows—debit and credit could be reversed)

5. ***Charitable Remainder Trust (NPO is trustee)*** (paragraphs 6.25 through 6.28)

NPO C enters into a charitable remainder unitrust agreement with a donor whereby:

- A trust is established by the donor, to be administered by NPO C.
- The donor's spouse is to receive an annual distribution of X percent of the fair market value of the trust's assets each year until the spouse dies.
- At the time of death of the donor's spouse, the remaining assets of the trust are to be distributed to NPO C as permanent endowment.

*Solution:*

Creation of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

cr. Contribution Revenue—Permanently Restricted

(Assets measured at fair value when received; liability measured at the present value of expected future cash flows to be paid to the beneficiary)

Over the term of the trust:

dr. Assets Held in Charitable Remainder Trust

cr. Liability Under Unitrust Agreement

(Trust income and change in fair value of assets held in trust, to the extent recognized)

dr. Liability Under Unitrust Agreement

cr. Assets Held in Charitable Remainder Trust

(Payment to beneficiary)

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Amortization of discount and adjustment of liability to reflect change in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Liability Under Unitrust Agreement

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(To close liability)

dr. Endowment Assets

cr. Assets Held in Charitable Remainder Trust

(To close trust and recognize assets as endowment)

6. ***Charitable Remainder Trust (NPO is not trustee)*** (paragraph 6.29)

The fact situation is the same as in the previous example, except that the NPO does not serve as trustee.

*Solution:*

Creation of the trust:

dr. Contributions Receivable from Remainder Trust

cr. Contribution Revenue—Permanently Restricted

(Beneficial interest measured at the present value of estimated future cash flows expected to be received by the NPO)

Over the term of the trust:

dr. Contributions Receivable from Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(Amortization of discount and changes in actuarial assumptions—debit and credit could be reversed)

Termination of the trust:

dr. Endowment Assets

cr. Contributions Receivable from Remainder Trust

cr. Change in Value of Split-Interest Agreements—Permanently Restricted

(NPO receives distribution of trust assets from trustee, measured at fair value; the receivable account is closed and the change in value of split-interest agreements reflects the difference)

7. ***Charitable Gift Annuity*** (paragraphs 6.30 through 6.33)

NPO D enters into a charitable gift annuity contract with a donor whereby:

- Assets are transferred to NPO D and are available for unrestricted use by NPO D.
- NPO D agrees to pay a stated dollar amount annually to the donor's spouse until the spouse dies, at which time the remaining assets are available for the unrestricted use of NPO D.

*Solution:*

Creation of the annuity:

dr. Assets

cr. Annuity Payment Liability

cr. Contribution Revenue—Unrestricted

(Assets measured at fair value when received, liabilities at the present value of expected future cash flows to be paid to the annuity beneficiary)

Over the term of the annuity:

dr. Annuity Payment Liability

cr. Cash

(Payment to annuity beneficiary)

dr. Change in Value of Split-Interest Agreements—Unrestricted

cr. Annuity Payment Liability

(Amortization of discount on liability and recording of any change in the life expectancy of the beneficiary—debit and credit could be reversed)

Termination of the annuity:

dr. Annuity Payment Liability

cr. Change in Value of Split-Interest Agreements—Unrestricted

(To close the annuity payment liability)

8. ***Pooled (Life) Income Fund*** (paragraphs 6.34 through 6.37)

NPO E forms, invests, and manages a pooled income (or life income) fund. The fund is divided into units, and contributions from many donors are pooled. Donors are assigned a specific number of units based on the proportion of the fair market value of the contribution to the total fair market value of the fund. A donor makes a contribution to the fund, is assigned a specific number of units, and will receive the actual income earned on those units until his or her death. The assets contributed must be invested in the fund until the donor's death. At that time, the value of the units assigned to the donor will revert to NPO E, and those assets will be available to NPO E without restriction.

*Solution:*

Contribution of assets:

dr. Assets of Pooled Income Fund

cr. Contribution Revenue—Temporarily Restricted

cr. Discount for Future Interest (Deferred Revenue)

(Assets recorded at fair value on date of receipt. Contribution revenue measured at the fair value of assets received, discounted for a term equal to the life expectancy of the donor.)

Over the term of the agreement:

dr. Assets of Pooled Income Fund

cr. Liability to Life Beneficiary

(Income earned on units assigned to donor) dr. Liability to Life Beneficiary

cr. Assets of Pooled Income Fund

(Payment to life beneficiary)

dr. Discount for Future Interest (Deferred Revenue)

cr. Change in Value of Split-Interest Agreements—Temporarily Restricted

(Amortization of discount and changes in the life expectancy of the beneficiary)

Termination of the agreement:

dr. Discount for Future Interest (Deferred Revenue)

cr. Change in Value of Split-Interest Agreement—Unrestricted

(To close discount upon the death of the life beneficiary)

dr. Cash or Investment Assets

cr. Assets of Pooled Income Fund

(To recognize assets available for use upon the death of the life beneficiary)

dr. Temporarily Restricted Net Assets—Reclassification Out

cr. Unrestricted Net Assets—Reclassification In

(Reclassification based on the expiration of the time restriction)

# Chapter 7
# *Other Assets*

## Introduction

**7.01** Some assets held by not-for-profit organizations are similar to those held by for-profit entities. This chapter considers assets that are not discussed elsewhere in this Audit and Accounting Guide (Guide) and that present accounting issues unique to not-for-profit organizations.

## Inventory

**7.02** Not-for-profit organizations may acquire merchandise inventory for resale; for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by not-for-profit organizations in exchange transactions or from contributions. (Paragraphs 5.10 through 5.19 and chapter 12, "Revenues and Receivables From Exchange Transactions," of this Guide, discuss exchange transactions.)

**7.03** Contributions of inventory should be reported in the period received and should be measured at fair value. Estimates of fair value may be obtained from published catalogs, vendors, independent appraisals, estimated selling prices, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (*a*) used internally by the not-for-profit organization or for program purposes or (*b*) sold by the organization, the item received should not be recognized. (Paragraphs 5.07 through 5.09 of this Guide discuss gifts in kind.)

## Prepaid Expenses, Deferred Charges, and Similar Costs

**7.04** Not-for-profit organizations may incur costs that relate to future rather than to current-period activities. Except as discussed elsewhere in this chapter, the recognition and measurement principles for those costs are similar to those used by business organizations. Accordingly, amounts expended for prepaid expenses and deposits should be reported as assets. (In conformity with Statement of Position [SOP] 93-7, *Reporting on Advertising Costs*, advertising costs should not be capitalized unless they are costs of direct-response advertising that is expected to result in future benefits, such as gift shop sales.)

## Collections

**7.05** Appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *collections* as follows:

Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

**7.06** Accounting for collections depends on whether an organization adopts a policy of recognizing collections as assets. When organizations initially adopt FASB Statement No. 116, they may choose to (*a*) capitalize their collections, including all items acquired in prior periods that have not been previously capitalized and all items acquired in future periods (that is, *retroactive capitalization*); (*b*) capitalize only those items acquired after initial adoption of FASB Statement No. 116 (that is, *prospective capitalization*); or (*c*) capitalize no collections. Capitalization of part of the collections (that is, *selective capitalization*) is prohibited.[1]

**7.07** If an organization adopts a policy of capitalizing collections, items acquired in exchange transactions should be recognized as assets in the period in which they are acquired and should be measured at cost. Contributed collection items should be recognized as assets and as contributions in the appropriate net asset class[2] and should be measured at fair value. Fair value can be best measured by the quoted market price of the contributed item. If such prices are not available, quoted market prices for similar items, appraised values, and other techniques may be used to estimate fair value.[3] Major uncertainties about the future service potential or economic benefit of contributed collection items, for example, items acquired for scientific or educational research having no alternative future uses, may indicate that they should not be recognized.

**7.08** If an organization adopts a policy of not capitalizing collections, no assets or contributions should be recognized from the acquisition of collection items. Cash flows from purchases, sales, and insurance recoveries of unrecognized, noncapitalized collection items should be reported as investing activities on the statement of cash flows. Additional disclosures described in paragraphs 7.12 and 7.13 should be made if an organization elects not to capitalize collections.

**7.09** Contributions made by not-for-profit organizations of previously recognized collection items should be reported as expenses and decreases in assets in the period in which the contributions are made, and should be measured at fair value. (A gain or loss should be recognized on contributions made of previously recognized collection items if their fair value differs from their carrying amount.) Contributions made by not-for-profit organizations of previously unrecognized collection items should not be recognized on the face of the financial statements; disclosure of those contributions should be made in notes to the financial statements.

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[1] Initial adoption of FASB Statement No. 116 may be reported by (*a*) retroactive restatement of opening net assets for the earliest year presented or, if no prior years are presented, for the year in which the Statement is first applied, or (*b*) reporting the effect as a change in accounting principle in conformity with paragraph 19 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

[2] Contributions should be classified as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and type of restrictions imposed by donors. Chapter 5, "Contributions Received and Agency Transactions," of this Guide, provides guidance concerning accounting for contributions with donor-imposed restrictions.

[3] For practical reasons, items that are retroactively capitalized on initial application of FASB Statement No. 116 can be recognized at their (*a*) cost or fair value at the date of acquisition or (*b*) cost or current market value at the date of initial recognition.

**7.10** Works of art, historical treasures, and similar assets that are not collection items should be recognized as assets. Items acquired in exchange transactions should be measured at cost. Contributions of those items should be measured at fair value at the date of contribution and should be recognized in a statement of activities as support that increases the appropriate net asset classes.

## Financial Statement Presentation

**7.11** If an organization adopts a policy of retroactively or prospectively capitalizing collections that meet the definition in FASB Statement No. 116, a statement of financial position should include the total amount capitalized on a separate line item, "Collections" or "Collection Items." The amount capitalized for works of art, historical treasures, and similar assets that do not meet the definition should be disclosed separately on the face of the statement of financial position or in the notes.

**7.12** A not-for-profit organization that does not recognize and capitalize its collections should report the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:[4]

- Costs of collection items purchased as a decrease in the appropriate class of net assets
- Proceeds from sale of collection items as an increase in the appropriate class of net assets
- Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets.

Similarly, an entity that capitalizes its collections prospectively should report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses.

**7.13** A not-for-profit organization that does not recognize and capitalize its collections or that capitalizes collections prospectively should describe its collections, including their relative significance, and its accounting and stewardship policies for collections. If collection items not capitalized are deaccessed during that period, it also should (*a*) describe the items given away, damaged, destroyed, lost, or otherwise deaccessed during the period or (*b*) disclose their fair value. In addition, a line item should be shown on the face of the statement of financial position that refers to the disclosures required by this paragraph. That line item should be dated if collections are capitalized prospectively, for example, "Collections acquired since January 1, 19X1 (Note X)."

## Illustrative Disclosures

**7.14** This section provides examples of notes to the financial statements that illustrate some of the financial statement disclosures concerning collection items.

### Example 1—Organizations That Capitalized Collections Prior to FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

The organization has capitalized its collections since its inception. If purchased, items accessioned into the collection are capitalized at cost, and if do-

[4] Paragraph 141 of FASB Statement No. 116 illustrates these disclosures.

nated, they are capitalized at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statement of activities as unrestricted or temporarily restricted support depending on donor restrictions, if any, placed on the item at the time of accession.

## Example 2—Organizations That Capitalize Collections Retroactively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

In 19X1, the organization capitalized its collections retroactively in conformity with FASB Statement No. 116. To the extent that reliable records were available, the organization capitalized collection items acquired prior to 19X1 at their cost at the date of purchase or, if the items were contributed, at their fair or appraised value at the accession date (the date on which the item was accepted by the Acquisitions Committee of the Board of Trustees). Other collection items, particularly those acquired prior to 19X1 when detailed curatorial records began to be maintained, have been capitalized at their appraised or estimated current market value. In some cases, collection items held solely for their potential educational value or historical significance were determined to have no alternative use and were not assigned values for the purpose of capitalization. The collection items capitalized retroactively were determined to have a total value of $11,138,100. This amount is reflected as a change in accounting principle on the statement of activities.

## Example 3—Organizations That Capitalize Their Collections Prospectively Upon Initial Adoption of FASB Statement No. 116

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their appraised or fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statement of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Collection items acquired prior to July 1, 19X0: Collection items accessioned prior to July 1, 19X0 were recorded as decreases in unrestricted net assets, if the items were purchased. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Note Y: Accounting Change

In 19X1, the organization adopted FASB Statement No. 116. The organization has determined that the cost to capitalize its collections retroactively would be excessive because records of the cost of purchased items and of the fair value at the date of contribution of donated items are unreliable or do not exist. However, such information is available for current-year acquisitions and will be maintained on an ongoing basis. Therefore, the organization has elected to capitalize prospectively all collection items acquired after July 1, 19X0, the date of initial adoption of FASB Statement No. 116.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects. Each of the items is cataloged for educational, research, scientific, and curatorial purposes, and activities verifying their existence and assessing their condition are performed continuously.

During 19X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. Because those items were purchased prior to July 1, 19X0, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in unrestricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

### Example 4—Organizations That Do Not Capitalize Collections

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items are acquired, or as temporarily or permanently restricted net assets if the assets used to purchase the items are restricted by donors. Contributed collection items are not reflected on the financial statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

Note Z: Collections

The organization's collections are made up of artifacts of historical significance, scientific specimens, and art objects that are held for educational, research, scientific, and curatorial purposes. Each of the items is cataloged, preserved, and cared for, and activities verifying their existence and assessing their condition are performed continuously. The collections are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

During 19X1, a significant number of American pioneer artifacts from the 1800s were destroyed while in transit to an exhibition in which they were to be displayed. These artifacts were contributed in 19XX, with a restriction that limited any future proceeds from deaccessions to acquisitions of artifacts from a similar period. As a result, the insurance proceeds of $22,000, which reimbursed the organization in full for the artifacts' fair value, are reflected as an increase in temporarily restricted net assets on the statement of activities. No other collection items were deaccessioned in 19X1 or 19X0.

## Auditing

**7.15** Many audit objectives, controls, and auditing procedures for other assets of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

## Inventory

**7.16** As discussed in paragraph 7.03, in certain circumstances, the fair value of contributed inventory may be measured using methods such as estimates, averages, or computational approximations. Such methods may be used in connection with the financial statement assertion of valuation. However, such methods are unrelated to the assertions of existence and occurrence. Auditors should be mindful of the provisions of Statement on Auditing Standards (SAS) No. 1, section 331, *Inventories* (AICPA, *Professional Standards,* vol. 1, AU sec. 331), which provides guidelines concerning inventory observation.

### *Collection Items*

**7.17** Examples of auditing procedures that might be applied for collection items are presented in the table at the end of this chapter. If collection items are not capitalized, the auditor should perform procedures to understand the organization's controls over recording accessions (including contributions) and deaccessions of collection items, controlling the collections, and periodically physically inspecting them. Those auditing procedures are performed, in part, to provide evidence supporting the disclosures required by paragraph 27 of FASB Statement No. 116. They are also part of the auditor's work in obtaining an understanding of the organization's controls over collection items and contributions of such items. The objective of performing those procedures when the collection is not recognized is not to obtain evidence to corroborate a recorded amount, since no amount has been recorded. Instead, the objective is to help the auditor understand the organization's control environment, which is a component of its internal control.

**7.18** As noted in chapter 2, "General Auditing Considerations," of this Guide, SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to understand the organization's control environment, an important part of which is management's philosophy and operating style and its integrity and ethics. Management's philosophy and operating style include management's approach to taking and monitoring business risks and its attitudes and actions toward financial reporting. Management's integrity and ethics include the emphasis management places on meeting budget, profit, and other financial and operating goals. The auditor needs to know about the control environment to be able to assess control risk as it relates to the various segments of the audit, because the control environment often has pervasive effects on how the auditor plans the entire audit, including those parts that are unrelated to collections and changes in them.

**7.19** The necessary understanding of the control environment does not include a requirement to test controls that are part of the control environment (or any other controls, for that matter), but merely to obtain knowledge about the design of relevant policies, procedures, and records, and whether they have been placed in operation by the entity. What is sometimes referred to as a *transaction review* or *walk-through* of relevant custodial controls would probably be adequate for the auditor to gain the requisite level of knowledge about controls over the collection as part of understanding the control environment.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Noncapitalized Collection Items* | | | |
| Valuation | Noncapitalized works of art, historical treasures, and similar assets meet the definition of "collections" in FASB Statement No. 116. | Policies and procedures for determining that noncapitalized assets are "collections." | Review policies and procedures determining the appropriateness of classifying assets as noncapitalized collections. |
| Presentation and Disclosures | Transactions involving noncapitalized collection items are appropriately displayed in the statement of activities and the statement of cash flows. | | Determine the appropriateness of display and disclosures related to noncapitalized collections. |
| | Appropriate disclosures referenced in a line item on the face of the statement of financial position, meet the requirements of FASB Statement No. 116. | | |
| Existence/ occurrence | Collection items exist. | Procedures for controlling collections and periodically physically inspecting them. | Review the organization's procedures for controlling collections and physically inspecting them. |
| | Collection items acquired in the current period by purchase and contribution were authorized. | Controls ensure that purchased collection items are authorized, contributed | Consider whether to observe the physical inspection. |
| | Deaccessions from collections | | |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | occurred and were authorized. | collection items are appropriately accessioned, and deaccessions are authorized. | Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records. |
| | | | Review documentation supporting accessions and deaccessions of collection items. |
| | | | Review minutes of governing board and governing board committee meetings for authorization of major accessions and deaccessions. |
| | | | Make inquiries of curatorial personnel about deaccessioned collection items. |
| Rights and obligations | Restrictions on contributed collection items have been met. | Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the presence or absence of restrictions. |
| | | | Review minutes of governing board and governing board committee meetings for evidence of restrictions. |
| | | | If specific collection items |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | | are restricted, review collection item transactions for propriety of use and disposition. |
| *Capitalized Collection Items (Excluding Matters Related to Retroactive Capitalization)* | | | |
| Existence/ occurrence | Collection items exist.<br><br>Collection items acquired in the current period by purchase and contribution were authorized.<br><br>Deaccessions from collections occurred and were authorized. | Procedures for controlling collections and periodically physically inspecting them.<br><br>Controls ensure that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized. | Review the organization's procedures for controlling collections and physically inspecting them.<br><br>Consider whether to observe the physical inspection.<br><br>Review actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records.<br><br>Review documentation supporting accessions and deaccessions of collection items.<br><br>Review minutes of governing board and governing board committee meetings for authorization of major accessions and deaccessions.<br><br>Make inquiries of curatorial personnel about |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | | deaccessioned collection items. |
| Completeness; valuation | All collection items acquired in exchange transactions are recognized as assets at cost.<br><br>All contributed collection items are recognized as assets and as contributions at fair value. | Controls exist to ensure that all purchases and contributions of collection items are recognized as assets (at cost and fair value, respectively) and that contribution revenues are recognized for contributed collection items. | Review minutes of governing board and governing board committee meetings for evidence of current period purchases and contributions.<br><br>Review documentation and procedures supporting the determination of cost or fair value. |
| Rights and obligations | Restrictions on contributed collection items have been met. | Contributions of collection items are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the presence or absence of restrictions.<br><br>Review minutes of governing board and governing board committee meetings for evidence of restrictions.<br><br>If specific collection items are restricted, review collection item transactions for propriety of use and disposition. |
| Presentation and disclosure | Contributed and deaccessioned collection items are reported in the appropriate net asset class. | | Review documentation underlying collection items for propriety of classification. |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Retroactive Capitalization of Collection Items* | | | |
| Existence/ occurrence; completeness; valuation; rights and obligations; presentation and disclosure | Retroactively capitalized collection items exist, are the property of the organization, are properly valued, and are reported in the appropriate net asset class; all collection items owned by the organization are capitalized. | Procedures for controlling collections and determining their cost or fair value at date of acquisition or their current cost or current market value at date of initial recognition. | Review documents and procedures supporting the determination of cost or fair value at date of acquisition or current cost or current market value at date of initial recognition.<br><br>Review donor correspondence to determine the presence or absence of restrictions.<br><br>Review minutes of governing board and governing board committee meetings for evidence of restrictions.<br><br>Review documentation underlying contributed collection items for propriety of classification.<br><br>Consider the need to apply provisions of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), in conjunction with determining the reliability of carrying values. |

# Chapter 8

# Investments[1]

## Introduction

**8.01** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, provides measurement guidance for investments in equity securities with readily determinable fair values and all investments in debt securities, as well as reporting standards for all investments held by not-for-profit organizations, subject to the exceptions in the following sentence.[2] FASB Statement No. 124 does not apply to investments in equity securities that are accounted for under the equity method or to investments in consolidated subsidiaries.

**8.02** FASB Statement No. 124 does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 are referred to in this Audit and Accounting Guide (Guide) as *other investments*. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and equity securities that do not have a readily determinable fair value. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and Statements of Position (SOP) that are superseded by this Guide included guidance concerning other investments. This Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this Guide, until such time as the FASB or the Accounting Standards Executive Committee (AcSEC) issues more definitive guidance.[3] Accordingly, this chapter provides no new measurement guidance on accounting for other investments. Instead, it incorporates the measurement guidance for other investments currently found in the various AICPA publications that are superseded by this Guide, except as stated in the next sentence. To the extent that the guidance in the AICPA publications that are superseded by this Guide requires all investments to be measured using the same measurement attribute, only other investments, rather than all investments, are required to be measured using the same measurement attribute. For example, if an AICPA publication that is superseded by this Guide permits investments to be carried at either cost or fair value, provided that the same attribute is used for all investments, and if equity securities with a readily determinable fair value are carried at fair value in conformity with the guidance in FASB Statement No. 124, other investments are permitted to be carried at either cost or fair value, provided that the same attribute is used for all other investments.

**8.03** Not-for-profit organizations acquire various kinds of investments by contribution or purchase. This chapter discusses the accounting recognition,

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[1] Cash held temporarily by a custodian for investment purposes may be included as part of investments on a statement of financial position rather than as cash.

[2] FASB Statement No. 124 is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

[3] Appendix A [paragraph 8.28] of this chapter summarizes the measurement guidance for other investments.

measurement, and disclosure requirements for investments in (*a*) equity securities with a readily determinable fair value not accounted for under the equity method and not required to be consolidated, (*b*) debt securities, and (*c*) other investments. Split-interest gifts, including investments held by others, are discussed in chapter 6, "Split-Interest Agreements," of this Guide.

**8.04** SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which is included as appendix B [paragraph 8.29] of this chapter, was issued in September 1994. The FASB is also studying the concept of a reporting entity and issues related to consolidations, the application of the equity method of accounting, and accounting for various types of joint ventures.[4] Accordingly, those matters are not covered by this Guide.

**8.05** For all investments except investments in equity securities that are accounted for under the equity method and investments in consolidated subsidiaries, this chapter provides accounting and auditing guidance concerning the initial recognition and measurement, investment income, the measurement attributes used for subsequent valuation, unrealized and realized gains and losses, and financial statement display and disclosure. Many of the requirements under generally accepted accounting principles in these areas are the same as those for for-profit entities; accordingly, this chapter focuses on those issues that are unique to not-for-profit organizations.

## Initial Recognition

**8.06** Investments are initially recorded at their acquisition cost (including brokerage and other transaction fees) if they were purchased and at fair value if they were received as a contribution or through an agency transaction.[5] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, includes guidance concerning distinguishing contributions from agency transactions and discusses the classification of contributions.

## Investment Income

**8.07** Investment income includes dividends, interest, rents, royalties, and similar payments and should be recognized as earned. The revenue (often referred to as income) should be reported as an increase in unrestricted, temporarily restricted, or permanently restricted net assets, depending on donor stipulations on the use of the income.[6] For example, if there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in unrestricted net assets. On the other hand, a donor may stipulate that a gift be invested in perpetuity, with the income to be used to support a specified program. The initial gift creates permanently restricted net assets; the investment income is temporarily restricted for support of the donor-

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[4] On October 16, 1995, the FASB released an exposure draft of a proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Policy and Procedures*.

[5] Guidance in this chapter concerning the classification of investment income, unrealized gains and losses, and realized gains and losses applies to investments other than investments held by a not-for-profit organization as an agent. If a not-for-profit organization is holding an investment as an agent and has little or no discretion in determining how the investment income, unrealized gains and losses, and realized gains and losses resulting from those investments will be used, those investment activities should be reported as agency transactions and, therefore, as changes in assets and liabilities, rather than as changes in net assets.

[6] Paragraph 8.17 discusses an alternative accounting policy for circumstances in which temporary restrictions on investment income are met in the same reporting period as the income is recognized.

specified program. If the restrictions on the income are met, the statement of activities should report a reclassification from temporarily restricted net assets to unrestricted net assets.

**8.08** FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities should report the gross amounts of revenues and expenses. It also notes, however, that "investment revenues may be reported net of related expenses, such as custodial fees and investment advisory fees, provided that the amount of the expenses is disclosed either in the statement of activities or in notes to financial statements" (paragraph 24 of FASB Statement No. 117). Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses investment expenses.

## Valuation Subsequent to Acquisition

**8.09** FASB Statement No. 124 provides that investments in equity securities with readily determinable fair value and all debt securities should be reported at their fair value. As noted in paragraph 8.02, AICPA guidance concerning the carrying amounts of other investments subsequent to acquisition is diverse. Organizations should follow the guidance in appendix A [paragraph 8.28] of this chapter for their other investments. That guidance is based on the AICPA Industry Audit Guides, Audit and Accounting Guides, and SOPs that are superseded by this Guide, and is intended to maintain the status quo for other investments held by each kind of not-for-profit organization covered by that literature until it is changed by the FASB or by AcSEC.

## Unrealized and Realized Gains and Losses

**8.10** Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost). To the extent that unrealized gains and losses are recognized, they should be reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period.[7]

**8.11** Realized gains and losses arise from selling or otherwise disposing of investments. Realized gains and losses should be reported in the statement of activities as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law.[8] (Paragraph 8.10 discusses unrealized gains and losses. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amount reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the

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[7] Paragraph 8.17 discusses an alternative accounting policy for circumstances in which temporary restrictions on gains are met in the same reporting period as the gains are recognized.

[8] See footnote 7.

realized amount (the difference between amortized cost and the sales proceeds) and the unrealized amount recognized in prior reporting periods. Table 8.1 below illustrates this reporting.)

**Table 8.1**

*Facts*

| | |
|---|---|
| 1. | In 19X1, a not-for-profit organization with a December 31 year end purchases an equity security with a readily determinable fair value for $5,000. |
| 2. | At December 31, 19X1, the fair value of the security is $7,000. |
| 3. | During 19X2, the security is sold for $11,000. |

*Reporting Gains and Losses*

| | |
|---|---|
| *19X1* | Recognize a $2,000 gain and adjust the carrying value to $7,000. (The reported gain equals $7,000 fair value less $5,000 carrying value.) |
| *19X2* | Recognize a $4,000 gain and adjust the carrying value to zero. (The gain may be reported as the net of $11,000 selling price less the $7,000 carrying value at the time the security was sold. Alternatively, the gain may be displayed as the realized gain of $6,000 [$11,000 selling price less $5,000 cost] less the $2,000 unrealized gain previously recognized.) |

## Investment Pools

**8.12** A not-for-profit organization may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools may vary from organization to organization.

**8.13** When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool categories (sometimes referred to as *participants*) based on the market value of the cash and securities placed in the pool by each participant. Current market value is used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably based on the number of units assigned to each participant.

## Donor-Restricted Endowment Funds

**8.14** A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. Donors or relevant law may require a not-for-profit organization to retain permanently some portion of gains and losses (net appreciation) on donor-restricted endowment funds. Unless net appreciation on donor-restricted endowment funds is temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets.[9] Paragraph 11 of FASB Statement No. 124 notes that "...if a donor allows the organization to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires that an amount be retained permanently. Instead, those gains are unrestricted if the investment income is unrestricted or are temporarily restricted if the investment income is temporarily restricted by the donor." Accordingly, in the absence of donor stipulations or law to the contrary, donor restrictions on the use of income of an endowment fund also extend to the net appreciation on the endowment fund.

**8.15** Classification of recognized gains and losses should be based on the underlying facts and circumstances. If limitations exist that preclude the use of net gains on permanently restricted net assets, either as a result of explicit or clear implicit donor stipulations or by the law of the relevant jurisdiction, the net gains are permanently restricted. Paragraph 125 of FASB Statement No. 117 notes that "because donor stipulations and laws vary, not-for-profit organizations must assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine if net appreciation on endowments is available for spending or is permanently restricted."

**8.16** Paragraphs 12 and 13 of FASB Statement No. 124 provide the following:

> 12. In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss occurs. Any remaining loss shall reduce unrestricted net assets.
>
> 13. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, [footnote omitted] gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

(After the fair value of the assets of the endowment fund equals the required level, gains that are restricted by the donor should be classified as increases in temporarily restricted net assets or permanently restricted net assets, depending on the donor's restrictions on the endowment fund.)

## Financial Statement Presentation

**8.17** Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the organization has a similar policy for reporting contributions received,[10] reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

**8.18** Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.

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[9] Legal limitations that require the governing board to act to appropriate net appreciation for expenditure under a statutorily prescribed standard of ordinary business care and prudence do not extend donor restrictions to the net appreciation. Accordingly, unless the donor has explicitly restricted the net appreciation on an endowment fund, net appreciation subject to such limitations should be reported as a change in unrestricted net assets.

[10] Paragraph 5.30 discusses the accounting policy for reporting contributions received if the organization meets donor-imposed restrictions on all or a portion of the amount contributed in the same reporting period as the contribution is received.

**8.19** Some not-for-profit organizations manage their investments on a total return basis. Under the total return concept, organizations focus on the overall return on their investments, including both investment income and net appreciation. They then use a spending-rate formula to determine how much of that return will be used for current operations.

**8.20** Under FASB Statement No. 117, however, all investment income and recognized gains and losses must be reported on the statement of activities and classified as unrestricted unless restricted by the donor or applicable law. Organizations are permitted to provide information on the face of the statement of activities and the notes to the financial statements about the total return on investments by segregating the total return between operating and non-operating components based on a spending-rate formula. If investment return reported in the statement of activities is separated into operating and nonoperating, certain information, as discussed in paragraph 8.23 of this Guide, is required to be disclosed. Those disclosures are illustrated in paragraphs 100 through 106 of FASB Statement No. 124.

**8.21** FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement Nos. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and 107, *Disclosures about Fair Value of Financial Instruments*.

**8.22** FASB Statement No. 119 requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

**8.23** For each period for which a statement of activities is presented, a not-for-profit organization should disclose:

*a.* The composition of investment return including, at a minimum, investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value

*b.* A reconciliation of investment return to amounts reported in the statement of activities if investment return is separated into operating and nonoperating amounts, together with a description of the policy used to determine the amount that is included in the measure of operations and a discussion of circumstances leading to a change, if any, in that policy

**8.24** For each period for which a statement of financial position is presented, a not-for-profit organization should disclose:

*a.* The aggregate carrying amount of investments by major types, for example, equity securities, U.S. Treasury securities, corporate debt securities, mortgage-backed securities, oil and gas properties and real estate

*b.* The basis for determining the carrying amount for investments other than equity securities with readily determinable fair values and all debt securities

*c.* The method(s) and significant assumptions used to estimate the fair values of investments other than financial instruments[11] if those other investments are reported at fair value

*d.* The aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

**8.25** For the most recent period for which a statement of financial position is presented, a not-for-profit organization should disclose the nature of and carrying amount for each individual investment or group of investments that represents a significant concentration of market risk.[12]

# Auditing

**8.26** Many audit objectives, controls, and auditing procedures for investments of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations and that are presented at the end of this chapter.

## Net Appreciation on Endowment Funds

**8.27** As discussed in this chapter, net appreciation on donor-restricted endowment funds should be reported as a change in unrestricted net assets unless the appreciation is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. Laws concerning net appreciation of donor-restricted endowment funds may vary from jurisdiction to jurisdiction. For example, some jurisdictions follow trust law, some follow the Uniform Management of Institutional Funds Act (UMIFA), some follow modifications of UMIFA, and some follow interpretations of those laws issued by state Attorneys General. Generally, in jurisdictions following trust law, net appreciation is not spendable and therefore should be added to permanently restricted net assets. Also, it has generally been interpreted that, absent donor restrictions, net appreciation is spendable under UMIFA and therefore should be added to unrestricted net assets. Auditors should obtain an understanding about these issues and the laws concerning net appreciation on donor-restricted endowment funds applicable to the reporting organization.[13] Also, auditors should obtain representations from management about any interpretations made by the organization's governing board concerning whether laws

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[11] Paragraph 10 of FASB Statement No. 107 requires organizations to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, amends FASB Statement No. 107 to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for certain nonpublic entities.

[12] Paragraph 20 of FASB Statement No. 105 requires organizations to disclose all significant concentrations of credit risk arising from financial instruments, whether from an individual counterparty or groups of counterparties.

[13] Auditors may find information available from State Societies of Certified Public Accountants, state Attorneys General, and industry publications useful in obtaining an understanding of these issues.

limit the amount of net appreciation of donor-restricted endowment funds that may be spent. However, for organizations operating in jurisdictions in which there may be questions concerning interpretations of the applicable laws or in which there are conflicting interpretations by various legal counsel, auditors should request the organization to obtain a specific opinion from legal counsel concerning interpretation of the legal requirements. (SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance concerning circumstances in which the auditor relies on the representations or work of an attorney for other than litigation, claims, and assessments as addressed in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).)

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Contributed Investments, Investment Income, Gains, and Losses* | | | |
| Rights and obligations; presentation and disclosure | Restrictions on contributed investments have been met.<br><br>Restrictions on investment income, net realized gains, and net recognized unrealized gains that are imposed by donors or by law have been met.<br><br>Investments and related income, gains, and losses are reported in the appropriate net asset class. | Contributions of investments and investment income, gains, and losses are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the existence of restrictions on, and classification of, investments and related income, gains, and losses.<br><br>Review minutes of governing board and governing board committee meetings for evidence of donor or statutory restrictions on, and classification of, investments and related income, gains, and losses.<br><br>If specific investments are restricted, review investment transactions for the propriety of dispositions. |
| *Reclassification of Restricted Net Assets* | | | |
| Presentation and disclosure | Restricted net assets are reclassified as unrestricted net assets in the statement of activities when restrictions are met on investment income restricted for support of donor-specified programs. | | Determine that appropriate reclassifications are made in the statement of activities when restrictions are met on investment income restricted for donor-specified programs. |

8.28

## Appendix A—Measuring Other Investments

1. Other investments of institutions of higher education, including colleges, universities, and community or junior colleges, that were acquired by purchase may be reported at cost, and contributed other investments may be reported at their fair market value or appraised value at the date of the gift, unless there has been an impairment of value that is not considered to be temporary. Other investments may also be reported at current market value or fair value, provided that the same attribute is used for all other investments. (Investments in wasting assets are usually reported net of an allowance for depreciation or depletion.) The financial statements or notes should set forth the total performance (that is, investment income and realized and unrealized gains and losses) of the other investment portfolio.

2. Voluntary health and welfare organizations should report other investments at cost if purchased and at fair market value at the date of the contribution if contributed. If the market value of the other investments portfolio is below the recorded amount, it may be necessary to reduce the carrying amount of the portfolio to market or to provide an allowance for decline in market value. If it can reasonably be expected that the organization will suffer a loss on the disposition of an investment, a provision for the loss should be made in the period in which the decline in value occurs. Carrying other investments at market value is also acceptable. The same measurement attribute should be used for all other investments and should be disclosed.

3. Not-for-profit organizations that are not colleges, universities, or voluntary health and welfare organizations (that is, those that were included in the scope of the Audit and Accounting Guide *Audits of Certain Nonprofit Organizations,* and Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*) should report other investments at either fair value or the lower of cost or fair value. The same measurement attribute should be used for all other investments. Declines in investments carried at the lower of cost or market value should be recognized when their aggregate market value is less than their carrying amount; recoveries of aggregate market value in subsequent periods should be recorded in those periods subject only to the limitation that the carrying amount should not exceed the original cost.

8.29

## Appendix B

# Statement of Position 94-3

# Reporting of Related Entities by Not-for-Profit Organizations

## September 2, 1994

Amendment to
AICPA Industry Audit Guides
*Audits of Voluntary Health and Welfare Organizations*
and *Audits of Colleges and Universities,*
AICPA Audit and Accounting Guide
*Audits of Certain Nonprofit Organizations,*
and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Prepared by the
Not-for-Profit Organizations Committee
Accounting Standards Division

## NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

In August 1996, the AICPA issued an Audit and Accounting Guide *Not-for-Profit Organizations* (the New Guide) which superseded the following AICPA Audit and Accounting Guides:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*

It also superseded the following AICPA Statements of Position (SOPs):

- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*
- SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*
- SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*

The New Guide is effective for financial statements for fiscal years ending on or after December 31, 1996. Earlier application is permitted.

This SOP applies to entities following the New Guide.

Readers should note the following matters:

- In July 1996, the AICPA issued an Audit and Accounting Guide *Health Care Organizations* that superseded the Audit and Accounting Guide *Audits of Providers of Health Care Services*. This SOP does not apply to entities following *Health Care Organizations*, just as it did not apply to entities following *Audits of Providers of Health Care Services*.
- References to pronouncements and guidance that are superseded have been shaded.
- In applying the guidance in paragraph 7, readers should refer to chapter 8, "Investments," of the New Guide. Not-for-profit organizations that choose to report investments at market value in conformity with the New Guide may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.
- Although the New Guide superseded SOP 78-10, it did not supersede the guidance in paragraph 13 of this SOP that "[e]ntities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so." Organizations that presented consolidated financial statements in conformity with the guidance in SOP 78-10 may continue to do so.

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# SUMMARY

This statement of position (SOP) amends and makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

The conclusions in this SOP are based on the premise that (1) whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated and (2) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

The guidance in this SOP focuses on (1) investments in for-profit entities and (2) financially interrelated not-for-profit organizations. That guidance includes the following:

## Investments in For-Profit Entities

- A reporting not-for-profit organization should consolidate a for-profit entity in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest if the guidance in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires consolidation. The manner in which the for-profit entity's financial position, results of operations, and cash flows are presented in the reporting organization's financial statements depends on the nature of the activities of the for-profit entity.
- A reporting not-for-profit organization should use the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to report investments in common stock of a for-profit entity if the guidance in that Opinion requires the use of the equity method.
- Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of reporting those investments by the equity method, which otherwise would be required by this SOP.

## Financially Interrelated Not-for-Profit Organizations

- A not-for-profit organization should consolidate another not-for-profit organization in which it has a controlling financial interest through direct or indirect ownership of a majority voting interest, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.
- A not-for-profit organization should consolidate another not-for-profit organization if the reporting not-for-profit organization has both control of the other not-for-profit organization, as evidenced by either ma-

jority ownership or a majority voting interest in the board of the other not-for-profit organization, and an economic interest in the other not-for-profit organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

- A not-for-profit organization may exercise control of another not-for-profit organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization. In such circumstances, the not-for-profit organization is permitted, but not required, to consolidate the other not-for-profit organization, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If a not-for-profit organization controls another organization in which it has an economic interest by means other than majority ownership or a majority voting interest in the board of the other not-for-profit organization and consolidated financial statements are not presented, the not-for-profit organization should make the financial statement disclosures specified in paragraph 12.
- If either (but not both) control or an economic interest exists, the financial statement disclosures required by FASB Statement No. 57, *Related Party Disclosures*, should be made.

The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, before its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

# Reporting of Related Entities by Not-for-Profit Organizations

## Introduction

1. The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,[1] nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.[2]

## Scope

2. This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:
  - Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
  - Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
  - SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*[3]
- Does not apply to entities or activities that are covered by the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

## Conclusions

3. This SOP provides guidance for reporting (*a*) investments in for-profit majority-owned subsidiaries, (*b*) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (*c*) financially interrelated not-for-profit organizations.

4. Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

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[1] *Consolidation* of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. *Combination*, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

[2] As discussed in appendix C, the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters. One of the phases of that project concerns financial reporting guidance for not-for-profit entities.

[3] SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

### Investments in For-Profit Majority-Owned Subsidiaries

**5.** Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB 51, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.

### Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

**6.** Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that Opinion requires use of the equity method, subject to the exception in paragraph 7 of this SOP. Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion 18 if the guidance in that Opinion requires them.

**7.** Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of applying the equity method to investments covered by paragraph 6 of this SOP.

### Financially Interrelated Not-for-Profit Organizations

**8.** Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control*,[4] and *economic interest*.

**9.** As discussed in paragraphs 10-13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph 10). Other kinds of control result in consolidation only if coupled with an economic interest (paragraph 11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph 12). The existence of control or an economic interest, but not both, is discussed in paragraph 13.

**10.** Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

**11.** In the case of (*a*) control through a majority ownership interest[5] by other than ownership of a majority voting interest, as discussed in paragraph 10, or control through a *majority voting interest in the board of the other entity* and (*b*) an economic interest in other such organizations, consolidation is

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[4] Words or terms defined in the Glossary are in italicized type the first time they appear in this SOP.

[5] Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms.

required, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.[6]

**12.** Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control
- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control
- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

**13.** In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph 11, or the disclosures, as discussed in paragraph 12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the disclosures set forth in FASB Statement No. 57.[7] Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

**14.** If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

## Effective Date and Transition

**15.** This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual

[6] Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported.

[7] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists.

expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

## APPENDIX A

# Background Information and Discussion of Conclusions

**A-1.** This appendix discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

## Background

### *Characteristics and Objectives of Financial Reporting*

**A-2.** FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states, among other things, that financial reporting by not-for-profit organizations should provide information—

> ...that is useful to...resource providers...in making rational decisions about the allocation of resources to those organizations. (paragraph 35)

and that is

> ...about the economic resources, obligations, and net rtesorces of an organization and the effects of transactions...that change resources and interests in those resources. (paragraph 43)

**A-3.** FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements*, examines the characteristics that make accounting information useful. The Statement sets forth a hierarchy of qualities, with usefulness for decision making being most important. The two primary characteristics that make accounting information useful are relevance and reliability. Comparability, which includes consistency, interacts with relevance and reliability to increase the usefulness of information.

**A-4.** Information about the nature of relationships and forms of control among not-for-profit organizations and between not-for-profit organizations and for-profit entities should contribute to the objectives set forth in FASB Concepts Statement No. 4, as well as meet the criteria for accounting information set forth in Concepts Statement No. 2. As indicated in paragraphs A-11 and A-12 of this SOP, the information currently presented in not-for-profit organizations' financial statements may not meet the objectives set forth in Concepts Statement No. 4.

**A-5.** Related but separate not-for-profit organizations and for-profit entities result from the following:

*a.* The decision of not-for-profit organizations to structure their operations in a manner that helps them achieve their mission

*b.* Investments by not-for-profit organizations in for-profit entities

### *Structure of Not-for-Profit Organizations*

**A-6.** Not-for-profit organizations conduct their operations through a variety of organizational structures. *The Not-For-Profit Organization Reporting Entity* (the Holder Report), a 1986 research report by William W. Holder, identifies three basic kinds of organizational structure:

*a.* *Simple structures*, consisting of a single entity that conducts all operations and activities of the organization

*b.* *Separate entities*, conducting individual program activities

c. *Single entity and separate entities*, conducting, respectively, program activities and support and other noncentral activities, such as fund-raising

### *Relationship of Separate Entities to Each Other*

**A-7.** The Holder Report, as well as other studies, identified a variety of relationships that could indicate that the resources and activities of an entity are controlled by another entity. Among the most widespread are the following:

- *Ownership*—One entity is the legal owner of another entity, either through stock ownership or some other means, such as membership in a membership corporation.
- *Board membership*—(*a*) One entity has the ability to appoint or elect a voting majority of the board of directors of another entity or (*b*) a voting majority of one entity's board, as a result of its charter or bylaws, is also a voting majority of the board of another entity.
- *Charter or bylaws*—The corporate charter or bylaws of an entity limits its activities to those that are beneficial to another entity.
- *Oversight relationship*—A national charter establishes conditions, such as financial relationships or an accreditation process, for a separate entity's use of a national name or participation in the activities of a national organization.
- *Contract*—The relationship between separate entities is spelled out in a written contract.

### *Factors Influencing Relationships of Separate Entities to Each Other*

**A-8.** According to the Holder Report, the most common reasons for establishing separate entities are the following:

- *Taxes*—To ensure the income tax deductibility of contributions by donors and to avoid problems of unrelated business income for taxation purposes
- *Legal*—To limit legal liability; protect funding sources; and avoid laws, rules, and regulations perceived to be overly restrictive
- *Organization*—To establish clear-cut organizational limits of authority and autonomy for various activities
- *Public identity*—To create a separate, distinct public identity for the specific activity in question

Generally, entities that are established for these reasons are not-for-profit organizations; however, they also may be for-profit entities, principally for tax reasons.

### *Not-for-Profit Organization Investment Portfolio Relationships*

**A-9.** Not-for-profit organizations' investment portfolios may include ownership interests in for-profit entities. Such investments generally are made to earn returns on assets rather than to conduct operating activities and frequently are held for long-term investment purposes. Some not-for-profit organizations holding such investments own more than 20 percent interests in these for-profit organizations; for example—

- A federated fund-raising organization may hold a majority interest in an oil company.
- A not-for-profit organization's endowment fund may include controlling interests in shopping malls, commercial buildings, and venture capital funds.

Current practice for reporting such investments is diverse, including cost, lower of cost or market, fair market value, and the equity method. Such investments generally are not reported by consolidating their financial statements with the financial statements of the reporting not-for-profit organizations.

### *Current Authoritative Literature*

**A-10.** Current authoritative literature on reporting the resources and activities of related entities of which one or more is a not-for-profit organization is inconsistent. Two noteworthy instances are the following:

- Appendix B discusses the inconsistencies in the AICPA audit and accounting guides and the SOP listed in paragraph 2 of this SOP. Efforts to correct or address these inconsistencies will take a long time, and no immediate guidance is anticipated other than this SOP.
- There has been uncertainty in practice over whether and to what extent certain pronouncements of the FASB—for example, FASB Statement No. 94—apply to not-for-profit organizations. In September 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

Appendix C summarizes other projects related to this SOP and their current status.

### *Needs of Financial Statement Users*

**A-11.** Because of the variety of organizational structures, the nature of the relationships among separate entities, and the inconsistency of the guidance in the current authoritative accounting literature, the needs of users of not-for-profit organizations' financial reports described in FASB Concepts Statement Nos. 2 and 4 may not be met.

**A-12.** Among the deficiencies noted by creditors, identified in the Holder Report, are the following:

- Relationships with and among affiliated entities and other related parties are not always clear and readily understandable in an organization's financial reports.
- Creditors sometimes are unable to understand the scope of activities and range of entities that make up the reporting entity simply by reading the financial reports.
- Substantially different reporting practices exist for similar economic circumstances.

Among the deficiencies noted by grantors and contributors, also identified in the Holder Report, are the following:

- Reporting for fund-raising and administrative activities sometimes is fragmented into more than one set of financial statements.
- The level of disclosure in financial statements about the kinds of activities conducted and the existence and inclusion of related entities is inadequate. Of specific concern is whether all the resources controlled and all the activities conducted by a not-for-profit organization are included in its financial statements.

### *Reporting and Disclosures*

**A-13.** Relationships between not-for-profit organizations and other entities range from complete control of the other entities by a central organization to a loose association. These relationships have resulted in the following eight financial reporting alternatives:

*a.* Consolidation or combination under the guidelines in ARB 51, FASB Statement No. 94, and SOP 78-10

*b.* Reporting the investment under the equity method of accounting for investments

*c.* Reporting the investment at cost

*d.* Reporting the investment at market

*e.* Reporting the investment at the lower of cost or market

*f.* Disclosures similar to those under the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

*g.* Related-party disclosures under the guidelines of FASB Statement No. 57

*h.* No reporting or disclosures

### *Consolidation and Combination*

**A-14.** Drawing on ARB 51, FASB Statement No. 94, paragraph 1, states:

> The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

**A-15.** SOP 78-10, which is included in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* and which predates FASB Statement No. 94, states in paragraphs 42 and 43:

> For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.
>
> The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

SOP 78-10, paragraph 44, states, in part:

> ...combined financial statements should be presented if (1) control exists as defined in paragraph 42 and (2) any of the following circumstances exists:
>
> *a.* Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
>
> *b.* A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
>
> *c.* A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

### *Equity Method*

**A-16.** APB Opinion 18 states in paragraph 17:

> ...the equity method of accounting for an investment in common stock should...be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

### *Disclosures*

**A-17.** Paragraph 13.04 of *Audits of Providers of Health Care Services* suggests presenting "summarized information about the assets, liabilities, results of operations, and changes in fund balances of related organizations" that "describe the nature of the relationships between...the related organizations."

**A-18.** FASB Statement No. 57 requires the following disclosures for material related-party transactions:

- The existence and nature of the relationship
- A description of the transactions between the entities, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects of those transactions on the reporting organization's financial statements
- The dollar volume of transactions between the entities and the effects of any changes in the method of establishing their terms from the preceding period
- Amounts due from or to the related entities, and, if not otherwise apparent, the terms and manner of settlement

## Discussion of Conclusions

### *Scope*

**A-19.** Consistent with the May 19, 1993, exposure draft of this SOP, this SOP does not apply to entities that are included in the scope of *Audits of Providers of Health Care Services*. AcSEC considered including those entities in the scope of this SOP but exempted them for practical purposes. The ways those entities are related to each other are evolving and may not be contemplated by this SOP. For example, many of those entities are affiliated based on participation in networks of health care providers, with complex contractual agreements that make it difficult to determine whether control and economic interest exist based on the definitions in this SOP. While AcSEC believes the basic principles in this SOP also may apply to those entities, further study and deliberation are necessary to determine whether this SOP would require clarification for it to be made operational for those entities. Further, AcSEC believes (*a*) there is a need for guidance now for entities included in the scope of this SOP and (*b*) including entities covered by *Audits of Providers of Health Care Services* in the scope of this SOP likely would delay its issuance. Accordingly, AcSEC concluded it should exclude entities that are required to follow *Audits of Providers of Health Care Services* from the scope of this SOP. Guidance for reporting related entities for entities covered by *Audits of Providers of Health Care Services* is expected to be included as part of the current project to revise that guide.

*Underlying Principles*

A-20. The conclusions in this SOP are based on the premise that (*a*) whether the financial statements of a reporting not-for-profit organization and those of one or more other entities (either a not-for-profit organization or a for-profit entity) should be consolidated and (*b*) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

*Control*

A-21. This SOP does not develop new concepts concerning the definition of control. Because the FASB currently has on its agenda a project on consolidations and related matters that may result in a definition of control different from that contained in SOP 78-10, AcSEC concluded that it should not revise the definition of control at this time.

*Relation to Other Guidance*

A-22. This SOP makes uniform the application of APB Opinion 18 and FASB Statement No. 94 for not-for-profit organizations with the following exception: This SOP permits not-for-profit organizations that otherwise would report their investment portfolios at market value in conformity with guidance in the not-for-profit audit guides to do so instead of adopting the equity method for unconsolidated subsidiaries and 50 percent or less owned entities. AcSEC permitted this exception because it believes uniform guidance will be issued by the FASB on reporting the overall investment activities of not-for-profit organizations as part of the FASB's project on not-for-profit organizations.

A-23. The conclusions in this SOP evolve from and consider the conclusions of SOP 78-10 and *Audits of Providers of Health Care Services* to provide uniform criteria for consolidation. They provide for financial statement disclosures that can be applied objectively and that can curb potential abuses in not reporting (*a*) the results of separate but related entities established by a not-for-profit organization to raise funds on its own behalf and (*b*) assets controlled by another not-for-profit organization. (This SOP does not revise *Audits of Providers of Health Care Services*.)

A-24. This SOP requires consolidation if there is an economic interest and control by either a majority voting interest in the board of the other entity or the ability to appoint a majority of its board members. Some not-for-profit organizations are related to each other in ways that would meet the definition of control under this SOP. However, in the case of some of the organizations, no such economic interest exists. In circumstances of control other than a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest, this SOP requires the existence of an economic interest for consolidation to be required or permitted. That provision is included in order to preclude the reporting of misleading information about the assets, liabilities, results of operations, and cash flows of the reporting organization.

*Economic Interest*

A-25. The Glossary of this SOP states that "[a]n *economic interest* in another entity exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other organization." The Glossary includes examples of circumstances that result in economic interests, including a reporting organization assigning certain of its functions to another entity. For example, an educational institution assigning its research functions to a research corporation that holds significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly, results in an economic interest in that research corporation. Also, an organization may have an economic interest in a lobbying organization if that lobbying organization conducts any of the organization's lobbying functions and uses significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly.

### *Circumstances Permitting but Not Requiring Consolidation*

**A-26.** Paragraph 12 of this SOP permits but does not require consolidation if the reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is achieved other than control through—

*a.* A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

*b.* A majority voting interest in the board of the other entity.

AcSEC considered requiring consolidation in all circumstances in which the reporting not-for-profit organization controls and has an economic interest in another not-for-profit organization. However, AcSEC believes consolidation may not be meaningful in all situations in which there is control and an economic interest. For example, some national organizations may control local chapters through affiliation agreements and receive funds from those local chapters. In such circumstances, both control and an economic interest exist. However, consolidation may not be meaningful. AcSEC encourages consolidation if—

*a.* The reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is other than control through—

   *i.* A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or

   *ii.* A majority voting interest in the board of the other entity and

*b.* Consolidation would be meaningful.

### *Disclosures*

**A-27.** AcSEC believes the disclosures required by this SOP in circumstances in which control exists by contract, agreement, or otherwise provide financial statement users with information that is more meaningful than the information they now receive under the existing not-for-profit audit guides. The disclosure requirements in this SOP are an interim step until the FASB completes its consolidations and related matters project.

### *Combined Financial Statements*

**A-28.** This SOP provides guidance concerning consolidated financial statements. As discussed in footnote 1, ARB 51 provides guidance concerning combined financial statements. Paragraph 22 of ARB 51 states that "there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements." This SOP prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled not-for-profit organizations, which may be presented, in certain circumstances, in conformity with the guidance in ARB 51.

***Parent or Subsidiary-Only Financial Statements***

**A-29.** This SOP provides no guidance concerning parent-entity-only or subsidiary-entity-only financial statements. Paragraph 15 of FASB Statement No. 94 precludes the use of parent-company financial statements for use as the general-purpose financial statements of the primary reporting entity. However, that Statement is silent concerning parent-company financial statements as other than general-purpose financial statements for the primary reporting entity. Generally accepted accounting principles do not preclude the issuance of subsidiary-only financial statements. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.

## APPENDIX B

# Other Financial Reporting Literature

**B-1.** The following discusses the authoritative and other financial reporting literature that is relevant to AcSEC's consideration of consolidated financial statements involving not-for-profit organizations. All references and discussion pertain to literature as it exists prior to being revised by this SOP. As discussed in paragraph 2, this SOP revises certain AICPA literature.

## SOP 78-10

**B-2.** SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, is discussed in paragraph A-15 of this SOP. (As discussed in paragraph 2 of this SOP, this SOP amends SOP 78-10.)

## Audits of Providers of Health Care Services

**B-3.** The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 13.02, recommends consolidation or combination of organizations related to health care entities by direct or common ownership in accordance with the provisions of ARB 51. In cases in which related organizations are controlled through means other than direct or common ownership and ARB 51 does not require consolidation, *Audits of Providers of Health Care Services* does not recommend consolidation or combination.

**B-4.** In circumstances in which *Audits of Providers of Health Care Services* does not recommend consolidation or combination, paragraph 13.04 of that guide requires disclosure of certain summarized information concerning the related organizations if control and at least one of the following circumstances exist:

*a.* The organization has solicited funds in the name of the health care entity and with the expressed or implied approval of the health care entity, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the health care entity or used at its discretion or direction.

*b.* The health care entity has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the health care entity.

*c.* The health care entity has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is acting primarily for the benefit of the health care entity.

(As discussed in paragraph 2 of this SOP, this SOP does not amend *Audits of Providers of Health Care Services*.)

## Audits of Colleges and Universities

**B-5.** The AICPA Industry Audit Guide *Audits of Colleges and Universities*, paragraph 11.09, states:

> For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, intercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

(As discussed in paragraph 2 of this SOP, this SOP amends *Audits of Colleges and Universities*.)

## Audits of Voluntary Health and Welfare Organizations

**B-6.** The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* provides no guidance on whether consolidated financial statements should be presented. However, paragraphs 7.08 and 7.09 provide guidance for determining whether auditors should audit the financial statements of organizations associated with the reporting not-for-profit organization. (As discussed in paragraph 2 of this SOP, this SOP amends *Audits of Voluntary Health and Welfare Organizations*.)

# APPENDIX C

# Other Projects Related to This SOP

## FASB Project on Consolidations and Related Matters

**C-1.** This project is addressing various issues concerning the reporting entity, including those relating specifically to not-for-profit organizations. The FASB issued its September 10, 1991, Discussion Memorandum, *Consolidation Policies and Procedures*. The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

## FASB Project on Investments

**C-2.** This project is addressing various issues concerning investments held by not-for-profit organizations. The project is in the preliminary stages. The conclusions in this SOP will be reconsidered when the FASB completes its project on investments, which may affect the conclusions concerning investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest and other related matters. [*In November 1995, the FASB issued FASB Statement No. 124,* Accounting for Certain Investments Held by Not-for-Profit Organizations, *which does not effect the conclusions of this SOP.*]

## AICPA Project on the Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations

**C-3.** In September 1994, AcSEC issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

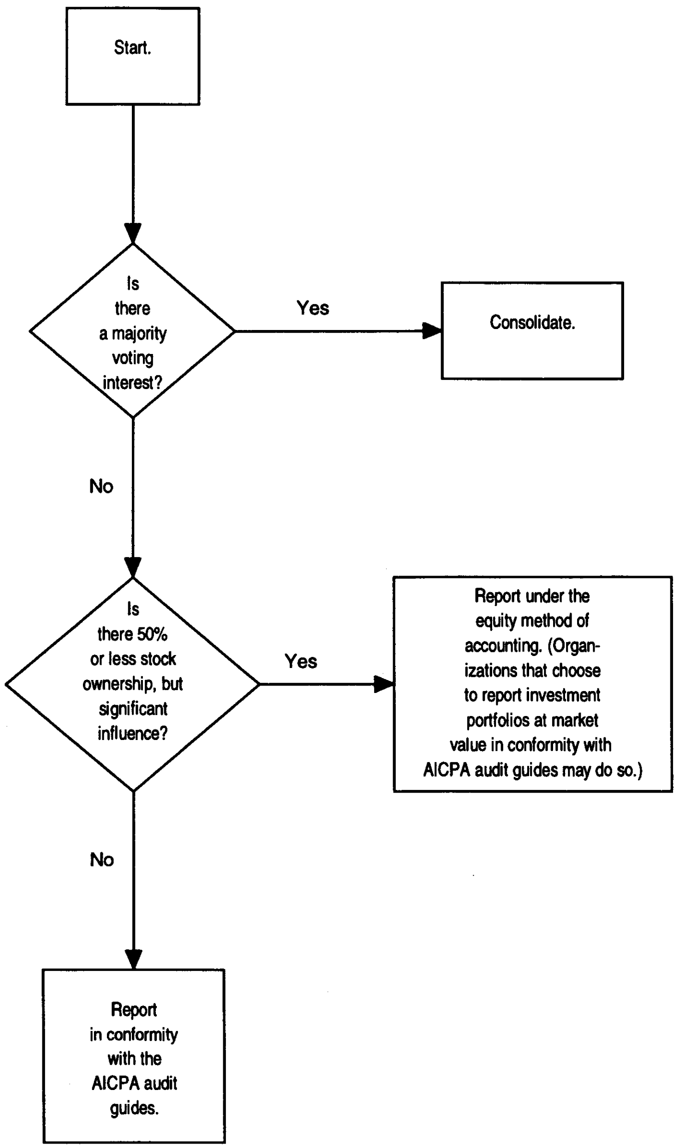
## AICPA Accounting and Audit Guide Revisions

**C-4.** The AICPA will revise the existing audit and accounting guides for not-for-profit organizations and colleges and universities to reflect the accounting and reporting requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, among other things.

## APPENDIX D

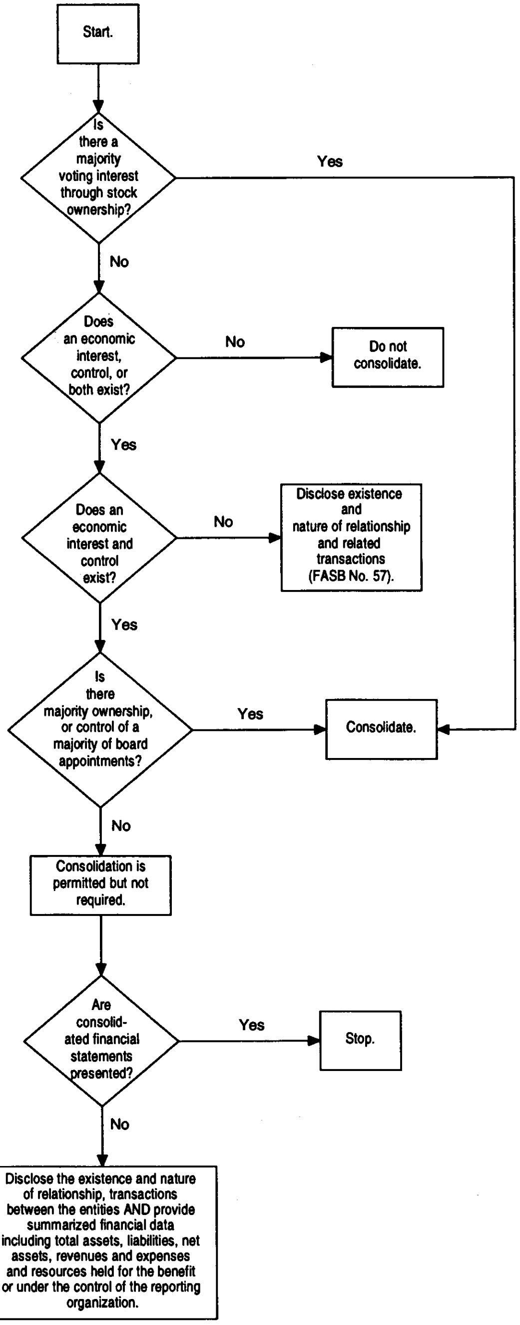
# Flowcharts and Decision Trees[8]

### Ownership of a For-Profit Entity




[8] The flowcharts and decision trees summarize certain guidance in this SOP and are not intended as substitutes for the SOP.

## Relationship With Another Not-for-Profit Organization



## Glossary

***Control.*** The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

***Economic interest.*** An interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of the reporting organization.
- A reporting organization assigns certain significant functions to another entity.
- A reporting organization provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

***Majority voting interest in the board of another entity.*** For purposes of this SOP, a majority voting interest in the board of another entity is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

# Chapter 9

# *Property and Equipment*

## Introduction

**9.01** Not-for-profit organizations use various kinds of property and equipment to provide goods and services to beneficiaries, customers, and members. Property and equipment includes all long-lived tangible assets held by not-for-profit organizations, except collection items[1] and assets held for investment purposes.

**9.02** Property and equipment commonly held by not-for-profit organizations include the following:

- Land used as a building site not subject to depreciation
- Land improvements, buildings and building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets
- Leased property and equipment (capitalized in conformity with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*)
- Improvements to leased property
- Construction in process
- Contributed use of facilities and equipment (recognized in conformity with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*)

## Recognition and Measurement Principles

**9.03** Not-for-profit organizations acquire the use of property and equipment through purchases, trade-ins, self-construction, leases, and contributions. Except as discussed in this chapter, the recognition and measurement principles for property and equipment acquired by not-for-profit organizations in exchange transactions are similar to those used by business organizations.

**9.04** Property and equipment used in exchange transactions (other than lease transactions), such as federal contracts, in which the resource provider retains legal title during the term of the arrangement should be reported as a contribution at fair value at the date received by the not-for-profit organization only if it is probable that the organization will be permitted to keep the assets when the arrangement terminates. The terms of such arrangements should be disclosed in notes to the financial statements. Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, discusses property and equipment held by not-for-profit organizations under federal award programs.

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[1] Because of their unique nature, collection items are reported differently from how other long-lived tangible assets are reported. Chapter 7, "Other Assets," of this Audit and Accounting Guide (Guide), discusses accounting for collection items.

## Contributed Property and Equipment

**9.05** Contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value[2] at the date of contribution and, depending on donor restrictions and the organization's accounting policy, should be included in permanently restricted,[3] temporarily restricted, or unrestricted net assets. If the donors stipulate how or how long contributed property and equipment must be used by the organization, the contribution should be reported as restricted support. If the donors do not specify such restrictions, the contribution should be reported as restricted support if the organization has adopted an accounting policy of implying a time restriction on the use of such assets that expires over the assets' useful lives. In the absence of donor restrictions or an organization's policy of implying time restrictions, contributions of long-lived assets should be reported as unrestricted support. Unconditional promises to give property and equipment should be recognized as receivables in conformity with FASB Statement No. 116 and with chapter 5 of this Guide. Contributions of the use of property and equipment in which the donor retains legal title to the assets are discussed in paragraphs 5.42 and 5.43.

**9.06** Similar to items acquired in exchange transactions, the amount initially recognized for contributed property and equipment should include all the costs incurred by the organization to place those assets in use. Examples of such costs include the freight and installation costs of contributed equipment and cataloging costs for contributed library books.

## Depreciation

**9.07** Paragraph 149 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, describes depreciation as a "systematic and rational" process for allocating the cost of using up assets' service potential or economic benefit over the assets' useful economic lives. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all not-for-profit organizations to recognize depreciation for all property and equipment except land used as a building site and similar assets and collections.[4] Depreciation should be recognized for contributed property and equipment as well as for plant and equipment acquired in exchange transactions.

**9.08** Depreciation expense should be reported in a statement of activities as a decrease in unrestricted net assets. If the property and equipment being depreciated have been contributed to the organization with donor-imposed restrictions on the item's use, temporarily restricted net assets should, over time, be reclassified as unrestricted net assets in a statement of activities as those restrictions expire. The amount reclassified may or may not be equal to the amount of the related depreciation. The amount to be reclassified should be based on the length of time indicated by the donor-imposed restrictions while the amount of depreciation should be based on the useful economic life

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[2] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses alternative methods of measuring the fair value of contributed assets.

[3] In practice, contributions of depreciable assets generally are not permanently restricted.

[4] The terms of certain grants and reimbursements from other organizations may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as *allowable costs*). Those terms should not affect the recognition and measurement of depreciation for financial reporting purposes.

of the asset. For example, a computer with an estimated useful economic life of five years may be contributed by a donor and restricted for a specific use by the organization for three years. Reclassifications are also necessary if the not-for-profit organization has adopted an accounting policy that implies a time restriction on contributions of property and equipment that expires over the useful life of the contributed assets. Reclassifications should be included as "Net Assets Released from Restrictions" in a statement of activities.

### *Impairment of Long-Lived Assets*

**9.09** In conformity with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, not-for-profit organizations should review long-lived assets to be held and used whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, organizations should estimate the future cash flows expected to result from (*a*) the use of the asset, such as fees or contributions, and (*b*) the asset's eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss should be recognized.[5] Otherwise, an impairment loss should not be recognized. Measurement of the impairment loss should be based on the fair value of the assets. The Statement also prescribes reporting and disclosure requirements for such losses.

**9.10** Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, provides guidance for certain assets to be disposed of. FASB Statement No. 121 provides that all long-lived assets and certain identifiable intangibles to be disposed of that are not covered by that Opinion and for which management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, should be reported at the lower of carrying amount or fair value less cost to sell. The Statement also prescribes reporting and disclosure requirements for such losses.

**9.11** The provisions of the Statement are effective for financial statements issued for fiscal years beginning after December 15, 1995. Impairment losses resulting from application of the Statement should be reported in the statement of activities in the period in which the recognition criteria are first met. The initial application of the Statement to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

## Gains and Losses

**9.12** Gains and losses recognized on property and equipment, including impairment losses recognized in conformity with FASB Statement No. 121,

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[5] Paragraph 8 of FASB Statement No. 121 provides that for purposes of estimating expected future cash flows, "assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of cash flows of other groups of assets." Paragraph 10 provides that in limited circumstances, the comparison of the estimated cash flows with the carrying amount of the assets "will be applicable only at the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings....If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement."

should be classified in a statement of activities as changes in unrestricted net assets unless explicit donor stipulations or law require their use to be restricted. In those situations, gains or losses should be classified as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate.

## Financial Statement Presentation

**9.13** A statement of financial position or related notes should include the balances of each major class of property and equipment. The basis of valuation—for example, cost for purchased items and fair value for contributed items—should also be disclosed. Separate disclosure should also be made of the following items:

- Nondepreciable assets
- Property and equipment not held for use in operations, for example, items held for sale or for investment purposes or construction in process
- Assets restricted by donors to investment in property and equipment
- Improvements to leased facilities and equipment
- Assets (and related obligations) recognized under capital leases (in conformity with FASB Statement No. 13)
- Capitalized interest (in conformity with FASB Statement Nos. 34, *Capitalization of Interest Cost*, and 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*)
- Disclosures required by FASB Statement No. 121, if applicable
- Significant accounting policies concerning property and equipment, such as the following:
  - The capitalization policy adopted
  - Whether time restrictions are implied on the use of contributed long-lived assets (and contributions of assets restricted to purchase them) received without donor stipulations concerning how long the contributed assets must be used[6]
  - Whether donor-restricted contributions of long-lived assets are reported as unrestricted or restricted support when restrictions are satisfied in the same reporting period in which the contributions are received[7]

**9.14** Accumulated depreciation, either for each major class of property and equipment or in total, should be disclosed (*a*) as a deduction or parenthetically in a statement of financial position or (*b*) in the notes to the financial statements. The amount of depreciation expense for the period and the method or methods used to compute depreciation for the major classes of property and equipment should also be disclosed.

**9.15** The notes to the financial statements should also include disclosures concerning the liquidity of the organization's property and equipment, includ-

[6] Paragraph 5.65 includes examples of how these alternative policies might be disclosed in notes to the financial statements.

[7] See footnote 6.

ing information about limitations on their use. For example, information should be provided about—

- Property and equipment pledged as collateral or otherwise subject to lien
- Property and equipment acquired with restricted assets where title may revert to another party, such as a resource provider
- Donor or legal limitations on the use of or proceeds from the disposal of property and equipment

## Auditing

**9.16** As discussed in chapter 5 of this Guide, a not-for-profit organization may have access to the use of property or equipment that is neither owned nor leased. For example, property or equipment may be provided by a related organization (such as a religious order), by unrelated organizations under affiliation programs, or by a governmental agency or unit. The auditor should inquire into, and the financial statements should disclose, the nature of any relationship between the organization and the owners of the property or equipment.

**9.17** Many audit objectives, controls, and auditing procedures for property and equipment of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Contributed Property and Equipment* | | | |
| Valuation | Contributed property and equipment is reported at fair value at the date of contribution. | Controls ensure that contributions of property and equipment are known and recorded and that documentation supports the determination of their fair value. | Review documentation supporting the determination of fair value. |
| Rights and obligations | Restrictions on contributed property and equipment have been met. | Contributions of property and equipment are reviewed for restrictions and management monitors compliance with restrictions. | Review donor correspondence to determine the presence or absence of restrictions.<br><br>Review minutes of governing board and governing board committee meetings for evidence of donor restrictions.<br><br>If specific property or equipment is restricted, review contributed property and equipment transactions for propriety of use and dispositions. |
| Presentation and disclosure | Property and equipment is reported in the proper net asset class. | | Review documentation underlying contributions of property and equipment for propriety of classification. |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Property and Equipment Not Held for Use in Operations* | | | |
| Presentation and disclosure | Property and equipment not used in operations but held as an investment or for sale is separately reported. | Property records segregate property and equipment not used for operating purposes. | Determine that property and equipment not held for operating purposes is reported separately. |
| *Property and Equipment Additions* | | | |
| Rights and obligations | Appropriate resource provider approvals, if required, have been obtained for property and equipment additions. | Management monitors compliance with resource provider regulations related to additions to property and equipment.<br><br>Additions are authorized in the capital budget. | Determine compliance with resource provider requirements. |
| *Reclassification of Temporarily Restricted Net Assets* | | | |
| Presentation and disclosure | Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities over the term of the donor-imposed restrictions. | | Determine that appropriate reclassifications are made on the statement of activities over the term of the donor-imposed restrictions. |

# Chapter 10
# *Debt and Other Liabilities*

## Introduction

**10.01** Many obligations of not-for-profit organizations are similar to those of for-profit entities. This chapter considers debt and other liabilities that are not discussed elsewhere in this Audit and Accounting Guide (Guide) and that present accounting and auditing issues unique to not-for-profit organizations.

## Tax-Exempt Financing

**10.02** Some not-for-profit organizations finance part of their activities from the proceeds of tax-exempt bonds and other obligations issued through state and local financing authorities. Because not-for-profit organizations are responsible for the repayment of those obligations, such financing should be reported as liabilities on their statements of financial position.

## Current and Deferred Tax Liabilities

**10.03** Although not-for-profit organizations are generally tax-exempt under various Internal Revenue Code (IRC) sections,[1] some may be subject to taxes on various portions of their income, such as federal excise taxes on investment income or federal and state income taxes on unrelated business income.[2] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, provides guidance on recognizing (*a*) the amount of taxes payable (or refundable) for the current year and (*b*) deferred-tax liabilities (and assets) for the estimated future tax consequences of temporary differences and carryforwards.

## Deferred Revenue

**10.04** Resources received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent that the earnings process has not been completed. For example, resources received from the advance sale of season theater tickets should be recognized as deferred revenue, representing the obligation to hold the performances. That revenue is earned as the theater performances are held.

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[1] Some organizations may meet the definition of a not-for-profit organization, as discussed in paragraphs 1.01 and 1.02 of this Guide, but may nevertheless not be tax-exempt under the IRC. For example, an organization that may otherwise qualify for tax-exempt status under the IRC may lose its tax exemption because it has violated the private inurement rules applicable to tax-exempt organizations. Chapter 15, "Tax Considerations," of this Guide, discusses various requirements for maintaining tax-exempt status under the IRC.

[2] Chapter 15 of this Guide discusses tax issues concerning not-for-profit organizations.

## Refunds Due to and Advances From Third Parties

**10.05** Some not-for-profit organizations receive (*a*) advances from third parties, such as government agencies and foundations, based on the estimated cost of providing services to constituents and (*b*) resources from third parties to be used to make loans to the organization's constituents. Advances from third parties for services not yet performed, as well as refunds due to third parties for amounts previously received under such agreements, should be included as liabilities on a statement of financial position.

## Promises to Give

**10.06** A promise to give carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. Paragraph 18 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, requires donors to recognize a liability for unconditional promises made to give cash or other assets to recipients or to settle or cancel the recipients' liabilities. Unconditional promises to give should be recognized at the time the donor has an obligation to transfer the promised assets in the future, which generally occurs when the donor approves a specific grant or when the recipient is notified. If a donor explicitly reserves the right to rescind an intention to contribute, or if a solicitation explicitly allows a donor to rescind the intention, a promise to give should not be recognized by the donor. If payments of the unconditional promise to give are to be made to a recipient over several fiscal periods and the recipient is subject only to routine performance requirements, a liability and an expense for the entire amount payable should be recognized and measured at the present value of the amounts to be paid. In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.[3] Conditional promises to give should not be recognized until the conditions are substantially met.[4]

**10.07** In conformity with paragraph 15 of APB Opinion No. 21, the interest method should be used to amortize discounts on contributions payable that are measured at present value. Other methods of amortization may be used if the results are not materially different. The discount should be amortized between the date the promise to give is initially recognized and the date the cash or other contributed assets are paid. The amortization of any discount related to unconditional promises to give should be reported as a component of contribution expense, in the same functional classification in which the promise to give was reported.

**10.08** In addition to disclosures required by FASB Statement Nos. 5, *Accounting for Contingencies*, and 47, *Disclosure of Long-Term Obligations*, the notes to the financial statements should include a schedule of unconditional promises to give that shows the total amount separated into amounts payable in less than one year, in one to five years, and in more than five years and the unamortized discount.

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[3] The discount rate may differ from the discount rate used to discount contributions receivable.

[4] Chapter 5, "Contributions Received and Agency Transactions," of this Guide, provides additional guidance for recognizing conditional promises to give.

## Annuity Obligations

**10.09** Some contributions received by not-for-profit organizations, such as interests in charitable gift annuity contracts and charitable remainder and lead trusts, impose obligations on the organization to make future payments to others. Guidance for reporting such contributions, often referred to as "split-interest agreements," is included in chapter 6, "Split-Interest Agreements," of this Guide. Annuity obligations arising from split-interest gifts should be recognized as liabilities and measured at the present value of the actuarially determined obligation. Periodic revaluations of these liabilities result in changes in the value of split-interest agreements, which should be included as changes in the appropriate net asset classes in a statement of activities.

## Amounts Held for Others Under Agency Transactions

**10.10** Some not-for-profit organizations receive assets in agency transactions. Amounts held under agency transactions should be included as liabilities in statements of financial position. Paragraphs 5.04 and 5.06 discuss agency transactions in more detail.

## Contingencies

**10.11** In conformity with FASB Statement No. 5, notes to the financial statements may have to include information about, or a liability may have to be accrued for, loss contingencies. Examples of circumstances that may result in such contingencies include the following:

- Noncompliance with donor-imposed restrictions on contributed assets
- Problems with the organization's tax-exempt status, or that a determination letter regarding that status has not been received

## Auditing

**10.12** Many audit objectives, controls, and auditing procedures for debt and other liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Tax-Exempt Financing* | | | |
| Completeness; presentation and disclosure | Amounts related to tax-exempt debt are recognized in the financial statements and related disclosures are adequate. | Reconcile outstanding balances and other relevant data with information received from the trustee. | Confirm outstanding balances and other relevant data with trustee.<br><br>Review financing agreements to ascertain that information about tax-exempt financing is properly reported and disclosed.<br><br>Review minutes of governing board and governing board committee meetings for information about tax-exempt financing. |
| *Promises to Give* | | | |
| Existence/ occurrence | Amounts recognized as contributions made and related liabilities represent valid unconditional promises to give. | Controls ensure that only unconditional contributions made and promises to give are recognized in the financial statements. | Examine documentation supporting recognition of contributions made and related liabilities, including information such as the absence of conditions and the periods over which the promises to give become due. |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| Completeness | All unconditional contributions made and promises to give are recognized. | Controls ensure that all unconditional contributions made and promises to give are recognized in the financial statements. | Review minutes of governing board and governing board committee meetings for information about contributions made and promises to give. |
| | | | Review cash disbursements subsequent to year-end to ascertain that contributions made were recorded in the proper period. |
| Valuation | Contributions made and related liabilities expected to be paid beyond one year are measured at the present value of the amounts expected to be paid. | | Review and test the method used for valuing promises to give collectible more than one year from the date of the financial statements. |

# Chapter 11

# Net Assets

## Introduction

**11.01** Paragraph 49 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *net assets* as "the residual interest in an entity's assets remaining after liabilities are deducted."[1] As a residual interest, net assets cannot be measured independently of an organization's assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many not-for-profit organizations, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. Display of and disclosures about net assets and changes in them are intended to assist donors and other users in assessing an organization's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

**11.02** Changes in net assets result from revenues, expenses, gains, and losses; those changes are discussed in chapters 5 through 10, 12, and 13 of this Guide. This chapter describes principles for reporting total net assets in statements of financial position and changes in total net assets in statements of activities, as well as related disclosures.

## Net Asset Classes

**11.03** The following three classes of net assets should, if applicable, be reported in statements of financial position: (*a*) permanently restricted, (*b*) temporarily restricted, and (*c*) unrestricted.[2] Net assets should be included in one of the three classes depending on the presence and type of donor-imposed restrictions limiting an organization's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the organization's purpose and nature.

**11.04** Donor-imposed restrictions generally apply to net assets. Donors may also restrict specific assets as to their use (for example, land contributed for a park) or over time (for example, contributed securities that must be held in perpetuity). Paragraphs 3.03 and 11.12 of this Guide discuss reporting requirements for specific assets that have been received with donor-imposed restrictions.

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[1] Though not-for-profit organizations may use other terms, such as *equity*, this Accounting and Auditing Guide (Guide) uses the term *net assets* to describe the residual interest.

[2] Though FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, encourages the use of the terms *unrestricted, temporarily restricted*, and *permanently restricted* net assets, other titles for these classes may also be used, and further disaggregation of total net assets may also be reported. For example, *equity* may be used for net assets and unrestricted net assets may be labeled *other* and subdivided into *board-designated* net assets and *undesignated* net assets.

## Permanently Restricted Net Assets

**11.05** Permanently restricted net assets must be maintained by the organization in perpetuity. Permanently restricted net assets increase when organizations receive contributions for which donor-imposed restrictions limiting the organization's use of an asset or its economic benefits neither expire with the passage of time nor can be removed by the organization's meeting certain requirements. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity and contributions of collection items (if they are capitalized[3]) required by the donor to be maintained permanently in the organization's collections should be recognized as increases in permanently restricted net assets.

**11.06** Permanently restricted net assets may also change as a result of increases and decreases in existing assets that are subject to permanent restrictions. For example, increases in the carrying amounts of assets that are invested in perpetuity because of donor-imposed restrictions should be recognized as increases in permanently restricted net assets to the extent that donor stipulations or applicable law requires those increases to be retained permanently.

## Temporarily Restricted Net Assets

**11.07** Temporarily restricted net assets are those net assets whose use by the organization has been limited by donors (*a*) to later periods of time or after specified dates[4] or (*b*) to specified purposes. For example, contributions restricted by the donor to use by the organization over the next five years or to support a specific future program should be recognized as increases in temporarily restricted net assets. Contributions of assets (such as equipment or buildings) that by their nature are used up over time and that the donor stipulates must be used by the organization should also be recognized as increases in temporarily restricted net assets.[5]

**11.08** Temporarily restricted net assets may also change as a result of increases and decreases in existing assets or the economic benefits embodied in those assets that are subject to donor-imposed temporary restrictions. For example, if the donor has stipulated that income earned on temporarily restricted net assets must be added to principal until the principal is spent for a restricted purpose, the income should be reported as increases in temporarily restricted net assets.

## Unrestricted Net Assets

**11.09** Unrestricted net assets include those net assets whose use is not restricted by donors, even though their use may be limited in other respects, such as by contract or by board designation. Changes in net assets arising from exchange transactions (except income and gains on assets that are restricted by donors or by law) should be included in the unrestricted class.

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[3] Chapter 7, "Other Assets," of this Guide, discusses accounting policies concerning the capitalization of collection items.

[4] Contributions received with restrictions that are met in the same reporting period may be reported as unrestricted if the organization discloses such a policy and reports consistently from period to period. Paragraph 5.30 provides further guidance concerning that policy.

[5] Some organizations may adopt an accounting policy of implying time restrictions on contributed long-lived assets in the absence of explicit donor-imposed restrictions. Paragraphs 5.33 and 5.34 provide additional guidance on alternative policies.

## Reclassifications

**11.10** Reclassifications of net assets—that is, simultaneous increases in one net asset class and decreases in another—should be made if (*a*) the organization fulfills the purposes for which the net assets were restricted, (*b*) donor-imposed restrictions expire with the passage of time or with the death of an annuity beneficiary (if the net assets are not otherwise restricted), (*c*) a donor withdraws, or court action removes, previously imposed restrictions, or (*d*) donors impose restrictions on otherwise unrestricted net assets.[6] For example, the amount of a donor's contribution that must be used by the organization for a specified program would be reclassified from temporarily restricted to unrestricted net assets in the period in which the organization conducts the program.[7] Paragraph 9.08 of this Guide discusses reclassifications concerning the use of contributed depreciable assets.

## Disclosure

**11.11** A statement of financial position should include, at a minimum, the amounts of total permanently restricted, temporarily restricted, and unrestricted net assets and the amount of total net assets. A statement of activities should include the amount of total changes in net assets and of changes in each net asset class. These amounts should articulate with the net asset amounts in the statement of financial position. Reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. Specific changes in each net asset class should be aggregated into reasonably homogeneous groups.

**11.12** Information about the following should be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity
- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

## Auditing

**11.13** Since net assets cannot be measured independently of an organization's assets and liabilities, the auditor's consideration of net asset balances generally focuses on the assertions about rights and obligations and presentation and disclosure. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

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[6] Paragraph 5.28 discusses donors imposing restrictions on otherwise unrestricted net assets.

[7] A purpose restriction is often fulfilled when the organization incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction. Paragraph 5.32 of this Guide discusses appropriate accounting when expenses are incurred for a purpose for which both unrestricted and temporarily restricted net assets are available.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| Rights and obligations | Net assets are used and accounted for in accordance with donor restrictions. | Management monitors compliance with donor restrictions. | Review minutes of governing board and governing board committee meetings for evidence of donor restrictions.<br><br>Determine compliance with donor restrictions; test expenditures to determine that restricted net assets are used for their restricted purposes. |
| Presentation and disclosure | Temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities when donor-imposed restrictions have been fulfilled. | Controls ensure that reclassification of temporarily restricted net assets occurs when donor-imposed restrictions have been fulfilled. | Determine that appropriate reclassifications are made on the statement of activities when donor-imposed restrictions have been fulfilled. |

# Chapter 12

# *Revenues and Receivables From Exchange Transactions*

## Introduction

**12.01** This chapter discusses recognition, measurement, and display issues for revenues and related receivables arising from exchange transactions.[1] Because of the specialized nature of investment activities, they are discussed separately in chapter 8, "Investments," of this Audit and Accounting Guide (Guide). Chapter 5, "Contributions Received and Agency Transactions," of this Guide, includes guidance on distinguishing exchange transactions from contributions and agency transactions.

## Revenues

**12.02** Paragraph 78 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *revenues* as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Exchange transactions that give rise to revenues for not-for-profit organizations typically involve their efforts to provide goods or services to members, clients, students, customers, and other beneficiaries for a fee.

**12.03** Revenues are distinguished from gains, which are increases in an organization's net assets from peripheral or incidental transactions. In some situations, judgment is required to determine whether an increase in net assets should be reported as a revenue or as a gain. That determination should be based on the relationship of the transaction to the organization's activities. Transactions and other events that would properly be considered part of one organization's ongoing major or central activities (and hence give rise to revenues) may be considered peripheral for other organizations (and hence give rise to gains). For example, sales of computer equipment by a college store should be reported as revenues if such sales are considered part of the college's ongoing major or central activities. Sales of old computer equipment used in a museum's administrative offices would, however, be reported as gains if such sales are peripheral and if the equipment were sold above book value. Chapter 13, "Expenses, Gains, and Losses," of this Guide, discusses reporting gains from exchange transactions.

## Recognition, Measurement, and Display

**12.04** The recognition, measurement, and display of revenues and related receivables arising from exchange transactions are similar for both not-for-profit and for-profit entities. Revenues from exchange transactions should be rec-

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[1] Paragraph 48 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, defines *exchange transactions* as "reciprocal transfers in which each party receives and sacrifices approximately equal value."

ognized based on accrual accounting principles and should be measured by the increase in cash, receivables, or other assets or by the decrease in liabilities resulting from the transaction.[2] Revenues from exchange transactions should be reported as increases in unrestricted net assets in a statement of activities. As discussed in chapter 3, "Basic Financial Statements," of this Guide, further classifications (for example, between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes stipulated by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.*

**12.05** Revenues from exchange transactions should generally be reported gross of any related expenses.[3] If the organization regularly provides discounts (such as financial aid for students that is not reported as an expense, reduced fees for services, or free services) to certain recipients of its goods or services, revenues should be reported net of those discounts.[4, 5]

**12.06** Receivables arising from exchange transactions should be reported at net realizable value if the amounts are due within one year. Long-term receivables should be reported in conformity with Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*. Receivables arising from exchange transactions should be reported net of allowances for uncollectible amounts, if applicable.

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[2] Consistent with generally accepted accounting principles, interest on loans made to students and to other individuals or organizations should be recognized as revenue when earned.

[3] Expenses that are directly related to specific gross revenues may, however, be displayed sequentially with those revenues. For example, gross revenues from special events less the direct costs related to those events, followed by a subtotal, may be reported in a statement of activities. Chapter 13 of this Guide discusses reporting of special events.

[4] Net revenue may be reported as a single line item in a statement of activities, or the gross revenue is permitted to be reported less the related discount, provided that the discount is displayed immediately beneath the revenue.

[5] Paragraph 13.07 provides guidance concerning whether reductions in amounts charged for goods or services should be reported as discounts or expenses.

# Chapter 13

# *Expenses, Gains and Losses*

## Introduction

**13.01** Generally, expenses, gains, and losses of not-for-profit organizations are similar to those of for-profit organizations and are recognized, measured, and displayed similarly. This chapter discusses certain expense, gain, and loss recognition, measurement, and display issues that are unique to not-for-profit organizations and that are not covered elsewhere in this Audit and Accounting Guide (Guide).

## Expenses

**13.02** Paragraph 80 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, defines *expenses* as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Expenses are distinguished from losses, which are decreases in an organization's net assets from peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the organization except those that result from expenses.

**13.03** Expenses should be reported in a statement of activities as decreases in unrestricted net assets. As discussed in chapter 3, "Basic Financial Statements," of this Guide, further classifications (such as between operating and nonoperating) may be incorporated within a statement of activities beyond the net asset classes required by FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*.

**13.04** Paragraph 26 of FASB Statement No. 117 specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities.[1] No similar requirement exists with respect to losses.[2] Voluntary health and welfare organizations[3] are

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[1] Reporting information about the functional classification of expenses may require the allocation of costs that benefit two or more functions. All references in this Guide to the allocation of costs of informational materials and activities that include a fund-raising appeal among functions are subject to the constraints imposed by applicable AICPA guidance on that subject. This Guide supersedes Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into this Guide in paragraphs 13.31 through 13.40. On September 10, 1993, the Not-for-Profit Organizations Committee of the AICPA issued an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, which would supersede the provisions in paragraphs 13.31 through 13.40 of this Guide.

[2] Paragraphs 13.02 and 13.12 through 13.14 of this Guide discuss the differences between expenses and losses.

[3] Voluntary health and welfare organizations are defined in appendix D of FASB Statement No. 117 and in the Glossary of this Guide.

required to report information about functional classifications, together with information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement.[4] FASB Statement No. 117 encourages but does not require other not-for-profit organizations to provide information about expenses by their natural expense classification.

## Expense Recognition Issues

**13.05** Expenses are recognized when an organization's economic benefits are used up in delivering or producing goods, rendering services, or other activities or when previously recognized assets are expected to provide reduced or no future benefits. Some expenses, such as cost of goods sold, are recognized simultaneously with revenues that result directly and jointly from the same transactions or other events as the expenses. Some expenses, such as salaries, are recognized when cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. Some expenses, such as depreciation, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide services. An expense or loss is also recognized if it becomes evident that the previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

### Fund-Raising Costs

**13.06** Fund-raising costs, including the cost of special fund-raising events, are incurred to persuade potential donors to make contributions to an organization and should be expensed as incurred.[5] Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods. These costs also should be expensed as incurred.

### Financial Aid and Other Reductions in Amounts Charged for Goods and Services

**13.07** Some not-for-profit organizations provide reductions in amounts charged for goods or services, such as financial aid provided by colleges and universities. Reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for goods or services provided to the organization, such as part of a compensation package. Amounts reported as expenses for such reductions should be reported in the same functional classification in which the

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[4] Not-for-profit organizations may have various kinds of functions. The discussion in this Guide focuses on program, management and general, and fund-raising for illustrative purposes, because the Accounting Standards Executive Committee and the Not-for-Profit Organizations Committee (Committees) believe the use of those functional classifications will likely become predominant practice. However, the Committees neither encourage nor discourage the use of those or other functional classifications. Accordingly, the classifications used in the matrix may include program, management and general, and fund-raising or other classifications, such as cost of sales or investing.

[5] Costs are incurred when the item or service has been received.

cost of the goods or services provided to the organization are reported. If reductions in amounts charged for goods or services provided by a not-for-profit organization are given other than in exchange for services provided to the organization, such amounts should be reported as follows:

- as expenses to the extent that the organization incurs incremental expense in providing such goods or services
- as discounts[6] if the organization incurs no incremental expense in providing such goods or services

### Advertising Costs

**13.08** SOP 93-7, *Reporting on Advertising Costs*, provides recognition, measurement, and disclosure guidance for the advertising activities of all entities, including not-for-profit organizations. (SOP 93-7 specifically notes, however, that fund raising by not-for-profit organizations is not considered advertising and is not within the scope of the SOP.) SOP 93-7 requires certain disclosures about advertising activities, including disclosure of total advertising costs for a period.

**13.09** SOP 93-7 defines *advertising* as "the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." Advertising by a not-for-profit organization also includes activities to create or stimulate a desire to use the organization's products or services that are provided without charge.

**13.10** Advertising costs should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising that results in probable future benefits. Direct-response advertising should be capitalized if it is expected to result in future benefits, as in sales resulting from direct response advertising of merchandise in excess of future costs to be incurred in realizing those revenues. If no future revenues are anticipated, however, because the products or services advertised are being provided by the organization without charge, there is no basis for capitalizing the costs of direct-response advertising after the first time the advertising takes place.

### Contributions Made

**13.11** FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, provides guidance on contributions made as well as contributions received. The recognition rules for contributions made are discussed in paragraph 10.06 of this Guide. The amortization of any discount related to unconditional promises to give should be reported in the same functional classification in which the promise to give was reported.

## Gains and Losses

**13.12** Revenues are inflows of assets that result from an organization's ongoing major or central operations and activities. Gains are increases in net assets resulting from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from revenues. Expenses are outflows of assets or incurrences of liabilities that result from an organization's ongoing major or central operations

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[6] Paragraph 12.05 provides guidance concerning display of discounts.

and activities. Losses are decreases in net assets from an organization's peripheral or incidental transactions and other events and circumstances affecting the organization other than those that result from expenses.

**13.13** Gains and losses result both from an organization's peripheral or incidental activities and from events and circumstances that stem from the environment and that are largely beyond the control of a particular organization and its management. Some gains and losses result from holding assets or liabilities while their values change, such as from changes in the fair value of securities or changes in foreign exchange rates. Other gains and losses result from natural catastrophes, such as fires, floods, and earthquakes. Still others result from transactions (such as an organization's sale of buildings and equipment that are no longer needed for its ongoing operations, or from its winning or losing a lawsuit) that are only peripheral or incidental to the organization.

**13.14** Transactions resulting in revenues for one not-for-profit organization may result in gains for another, which, in turn, determines how the related costs should be classified and displayed. Revenues and expenses are reported gross (except for investment revenues and related expenses, which are permitted to be reported net of related expenses, as discussed in paragraphs 8.08 and 13.23), while gains and losses may be reported net. Gains and losses should be reported as increases or decreases in unrestricted net assets unless their use is restricted by a donor or by law, in which case they should be reported as increases or decreases in temporarily restricted or permanently restricted net assets, as appropriate. Losses need not be reported by their functional classification or in the matrix that presents information about expenses according to both their functional and natural classifications.

## Reporting Costs Related to Sales of Goods and Services

**13.15** The way that costs related to sales of goods and services are displayed depends on whether the sales constitute a major or central activity of the organization or a peripheral or incidental activity. For example, a museum that has a store that is a major or central activity should report and display separately the revenues from the store's sales and the related cost of sales. Cost of sales is permitted to be reported immediately after revenues from sale of merchandise, and may be followed by a descriptive subtotal, or cost of sales may be reported with other expenses. If the store sells merchandise that is related to the museum's program, the store would be a program service and the cost of the store's sales would be reported as a program expense. In other circumstances, cost of sales could be reported as a separate supporting service. For example, if operating a cafeteria is a major or central activity but is not related to the organization's programs, the cafeteria's cost of sales would be reported as supporting services.

**13.16** In contrast, a church that occasionally produces and sells a cookbook (considered to be a peripheral or incidental activity) has gains (or losses) from those sales, and the receipts and related costs are permitted to be offset and only the net gains (or losses) are reported. (These losses are not classified as an expense so they should not be reported by their functional classification.)

## Reporting the Cost of Special Events and Other Fund-Raising Activities

**13.17** Some organizations conduct fund-raising activities, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

**13.18** Organizations may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the organization could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.

**13.19** For example, assume an organization has a special event that is an ongoing and major activity with a ticket price of $100. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include administrative costs of $5 and fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.

**13.20** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

**Illustration 1**

| | | |
|---|---|---|
| Changes in unrestricted net assets: | | |
| Contributions | | $200 |
| Special event revenue | 100 | |
| Less: Costs of direct benefits to donors | (25) | |
| Net revenues from special events | | 75 |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 25 |
| Fund raising | | 30 |
| Total other expenses | | 115 |
| Increase in unrestricted net assets | | $160 |

**Illustration 2**

Changes in unrestricted net assets:

| | | |
|---|---|---|
| Revenues: | | |
| Contributions | $200 | |
| Special event revenue | 100 | |
| Total revenues | | 300 |
| Expenses: | | |
| Program | 60 | |
| Costs of direct benefits to donors | 25 | |
| Management and general | 25 | |
| Fund raising | 30 | |
| Total other expenses | | 140 |
| Increase in unrestricted net assets | $160 | |

**Illustration 3**

| | | |
|---|---|---|
| Contributions | | $270 |
| Dinner sales | 30 | |
| Less: Costs of direct benefits to donors | (25) | |
| Gross profit on special events | | 5 |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 25 |
| Fund raising | | 30 |
| Total other expenses | | 115 |
| Increase in unrestricted net assets | | $160 |

**13.21** Paragraphs 25 and 138 of FASB Statement No. 117 permit, but do not require, organizations to report receipts from special events that are peripheral or incidental activities net of related costs, without reporting those costs on the face of a statement of activities. Costs netted against receipts from peripheral or incidental special events should be limited to direct costs.

**13.22** The frequency of the events and the significance of the gross revenues and expenses distinguish major or central events from peripheral or incidental events. Events are ongoing major and central activities if (*a*) they are normally part of an organization's strategy and it normally carries on such activities or (*b*) the event's gross revenues or expenses are significant in relation to the organization's annual budget. Events are peripheral or incidental if they are not an integral part of an organization's usual activities or if their gross revenues or expenses are not significant in relation to the organization's annual budget. Accordingly, similar events may be reported differently by different organizations based on the organization's overall activities.

## Investment Revenues, Expenses, Gains, and Losses

**13.23** Investment revenues may be reported net of related expenses, such as custodial costs and internal and external investment advisory costs, provided that the amount of such expenses is disclosed either on the face of a statement of activities or in notes to the financial statements. Expenses that are netted against investment revenues should, however, be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format (if the organization presents that statement). Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities. Chapter 8, "Investments," of this Guide, includes a more detailed discussion of investment gains and losses.

# Functional Reporting of Expenses

**13.24** As has been previously noted, FASB Statement No. 117 requires the presentation, in either a statement of activities or the notes to the financial statements, of information about expenses (but not losses) reported by their functional classification, such as major classes of program services and supporting activities. Program services are defined in paragraph 27 of FASB Statement No. 117 as "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs." Program services may include cost of sales and costs of other revenue-generating activities that are program related. Supporting services are defined in paragraph 28 as "all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund-raising, and membership-development activities." Supporting services may include, as one or more separate categories, cost of sales and costs of other revenue-generating activities that are not program related. FASB Statement No. 117 provides examples of the kinds of activities that fall into each of those categories, and further elaboration is provided in the following sections.

## Functional Classifications

### *Program Services*

**13.25** The number of functional reporting classifications for program services varies according to the nature of the services rendered. For some organizations, a single functional reporting classification may be adequate to portray what may, in effect, be a single, integrated program service that the organization provides. In most cases, however, several separate and identifiable services are provided, and in such cases the expenses for program services should be reported by the kind of service function or group of functions. For example, a large university may have programs for student instruction, research, and public service, among others. A health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others. A federated fund-raising organization's programs may include making contributions to organizations supported by the federated fund-raising organization.

**13.26** Paragraph 26 of FASB Statement No. 117 specifies that information about expenses should be reported by their functional classification, such as *major* classes of program services and supporting activities. For guidance on what constitutes *major* classes of programs and supporting activities, not-for-profit organizations may consider, among other sources, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise.*[7]

**13.27** The financial statements should provide information about program expenses. If the components of total program expenses are not evident from the details provided on the face of the statement of activities (for example, if cost of sales is not identified as either program or supporting services), the notes to the financial statements should disclose total program expenses and should provide information about why total program expenses disclosed in the notes does not articulate with the statement of activities. The financial statements should also provide a description of the nature of the organization's activities, including a description of each of its major classes of programs, either on the statement of activities (for example, using column headings) or in the notes to the financial statements.

### Supporting Services

**13.28** Not-for-profit organizations may have various kinds of supporting activities, such as management and general, fund raising, and membership development. Some industries have functional categories of supporting activities that are prevalent in that industry. For example, colleges and universities typically have institutional support and institutional development activities. A single functional reporting classification is ordinarily adequate to portray each kind of supporting service. Organizations may, however, present more detailed disaggregated information for each kind of supporting service. For example, fund-raising expenses and the corresponding support that is obtained may be reported separately for each kind of fund-raising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

**13.29** *Management and general* activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They include oversight, business management, general record keeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. The costs of oversight and management usually include the salaries and expenses of the governing board, the chief executive officer of the organization, and the supporting staff. (If such staff spend a portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses should be allocated among those functions.) The costs of disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among

[7] FASB Statement No. 14 applies only to business enterprises; however, the Statement's guidelines may be helpful to not-for-profit organizations in determining the number of functional classifications that would be appropriate in their particular circumstances. Applying paragraph 11 of FASB Statement No. 14 to not-for-profit organizations, the major classes of program services and supporting activities should be determined by (*a*) identifying the major programs and activities that an organization undertakes, (*b*) grouping those programs and activities by function, and (*c*) selecting those functions that are significant with respect to the organization as a whole.

other costs, should similarly be classified as management and general expenses. The costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not), should be classified as management and general expenses.

**13.30** *Fund-raising activities* involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others. (Paragraph 13.49 discusses how fund-raising activities of federated fund-raising organizations should be reported.) The financial statements should disclose total fund-raising expenses.

**13.31** Many not-for-profit organizations solicit financial support from the public through a variety of fund-raising activities, including direct mail, door-to-door canvassing, telephone solicitation, telethons, and special events. Some of the costs incurred by such organizations are clearly identifiable with fund-raising, such as the cost of fund-raising consulting services. However, organizations often incur joint costs, such as postage and other communication costs, in distributing materials or performing activities that relate to several functions, including program activities, fund-raising, or other supporting services. It is often difficult to distinguish the amounts of joint costs that relate to each function.

**13.32** The guidance in paragraphs 13.33 through 13.40 applies only to joint costs of informational materials and activities that include a fund-raising appeal. Allocations of other joint costs are permitted under existing authoritative literature. Also, paragraphs 13.33 through 13.40 do not address the issue of how to allocate joint costs.[8] A number of cost accounting techniques are available for that purpose.

**13.33** All joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds. However, if it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with the appeal for funds, joint costs should be allocated between fund-raising and the appropriate program or management and general function.

**13.34** Demonstrating that a bona fide program or management and general function has been conducted in conjunction with an appeal for funds requires verifiable indications of the reasons for conducting the activity. Such indications include the content of the non-fund-raising portion of the activity; the audience targeted; the action, if any, requested of the recipients; and other corroborating evidence, such as written instructions to parties outside the organization who produce the activity, or documentation in minutes of the organization's board of the organization's reasons for the activity.

**13.35** Most fund-raising appeals include descriptions of the causes for which the entities exist and the planned uses of the funds, to inform prospective donors why funds are needed and how they will be used. Unless an appeal

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[8] Paragraphs 13.42 through 13.46 of this Guide discuss classification of expenses related to more than one function.

is designed to motivate its audience to action other than providing financial support to the organization, all costs of the appeal should be charged to fund-raising.

**13.36** In order to accomplish their basic missions, some organizations educate the public and seek the involvement of the public in the attainment of their missions by telling people what they can or should do about particular issues. Those organizations should allocate joint costs to program activities if the informational materials or activities further those program goals.

**13.37** Two examples of situations in which it may be appropriate to allocate such joint costs to program activities follow:

*a.* A voluntary health and welfare organization describes the symptoms of a disease and the action an individual should take if those symptoms occur.

*b.* An organization whose purpose is to raise public awareness alerts individuals to a social or community problem and urges their action in seeking changes.

**13.38** The content of the message is an important factor, but content alone may not be a conclusive indication of the reason for the activity. For example, if an audience is selected principally because of the organization's perception of its need for or interest in the educational information and not for its capacity to support the organization financially, any accompanying fund-raising appeal would appear to be incidental and the joint costs of the educational activity would not be required to be allocated. Conversely, if the audience is selected based on its presumed ability to provide financial support without consideration of its need for the educational information, the purpose would appear to be entirely fund-raising, and all joint costs should be considered fund-raising costs regardless of any accompanying educational message.

**13.39** All circumstances surrounding informational materials and activities that include a fund-raising appeal should be examined, and the criteria in paragraphs 13.33 through 13.38 of this Guide should be applied together rather than separately.

**13.40** Not-for-profit organizations incurring joint costs of informational materials and activities that include fund-raising appeals should disclose in their financial statements that such costs have been allocated, the total amount allocated during the period, and the portion allocated to each functional expense category. The following illustrates such disclosure.

Note X. Allocation of Joint Costs

In 19XX, the organization incurred joint costs of ______ for informational materials and activities that included fund-raising appeals. Of those costs, ______ was allocated to fund-raising expense, ______ was allocated to Program A expense, ______ was allocated to Program B expense, and ______ and was allocated to management and general expense.

**13.41** *Membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising, and the related costs should be reported as fund-raising costs. Membership development activities may be conducted in conjunction with other activities. The costs of activities that include membership development should be allocated to membership development and one or more other functions if the membership development activities are conducted in conjunction with other activities. For example, membership may entitle the members to group life and other insurance at reduced costs because of the organization's negotiated rates and to a subscription to the organization's magazine or newsletter; part of the membership dues may also represent a contribution.[9] Under these circumstances, an appropriate part of the costs of soliciting members should be allocated to the membership-development function, a part to program services, and a part to fund-raising activities.[10]

## Classification of Expenses Related to More Than One Function

**13.42** Some expenses are directly related to, and can be assigned to, a single major program or service or a single supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include salaries of persons who perform more than one kind of service and the rental of a building used for various programs and supporting activities.

**13.43** Direct identification of specific expense (also referred to as *assigning* expenses) is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function. For example, travel costs incurred in connection with a program activity should be assigned to that program.

**13.44** If direct identification (that is, assignment) is impossible or impracticable, an allocation is appropriate. The techniques used to allocate are common to all entities, for-profit and not-for-profit alike. A reasonable allocation of expenses among an organization's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods.[11] The paragraphs that follow provide guidance (in addition to that presented throughout this chapter) on allocating or presenting certain costs that may be incurred by not-for-profit organizations.[12]

**13.45** The allocation may be based on related financial or nonfinancial data. For example, the expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. Occupying and maintaining a building is not a separate supporting service. Interest costs,[13] including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible; interest costs that cannot be allocated should be reported as part of the management and general function.

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[9] Paragraph 5.15 and Table 5.2 of this Guide provide indicators to help make these distinctions.

[10] Footnote 1 to this chapter describes guidance in this Guide and a proposed SOP that provide guidance on accounting for the costs of materials and activities that include a fund-raising appeal.

[11] Footnote 1 to this chapter describes guidance in this Guide and a proposed SOP that provide guidance on accounting for the costs of materials and activities that include a fund-raising appeal.

[12] The guidance found in U.S. Office of Management and Budget Circular A-122 may also be helpful in allocating costs.

[13] Paragraph 21 of FASB Statement No. 34, *Capitalization of Interest Cost*, requires disclosure of total interest costs incurred.

**13.46** An organization should evaluate its expense allocation methods periodically. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.

### *Support to Affiliated Organizations*

**13.47** Some organizations make payments or provide other support to local or national affiliates. The specific purposes and benefits of those payments may be determinable (for example, permission to raise funds in a specified geographical area, or the provision of joint purchasing arrangements and technical and fund-raising assistance, functions that the organization would otherwise have to carry out itself), or the purposes and benefits may be indeterminable. Payments in the form of grants and dues may also be made to affiliates.

**13.48** Payments to affiliated organizations should be reported by their functional classification to the extent that it is practicable and reasonable to do so and the necessary information is available, even if it is impossible to allocate the entire amount of such payments to functions. Payments to affiliates that cannot be allocated to functions should be treated as a separate supporting service, reported on a statement of activities as a separate line item, and labeled "unallocated payments to affiliated organizations."

## Expenses of Federated Fund-Raising Organizations

**13.49** Federated fund-raising organizations solicit and receive designated and undesignated contributions and make grants and awards to other organizations. The fund-raising activities of these organizations, including activities related to fund-raising on behalf of others, should be reported as fund-raising expenses.

# Income Taxes

**13.50** If a not-for-profit organization incurs income tax expense, the notes to the financial statements should disclose the amount of the taxes and describe the nature of the activities that generated the taxes.

# Auditing

**13.51** Many audit objectives, controls, and auditing procedures for expenses, gains, and losses of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| *Expenses* | | | |
| Presentation and disclosure | Expenses are properly classified and displayed. | Controls ensure that expenses are properly classified and displayed. | Compare current period expenses in total and by functional classification with expectations based on prior-period expenses and/or budget and obtain explanations for variances from expectations.<br><br>Determine that expenses have been properly assigned and allocated to functional and, if applicable, natural classifications. |

# Chapter 14

# Reports of Independent Auditors

## Reports on Financial Statements

**14.01** The guidance in Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), applies to auditors' reports on the financial statements of not-for-profit organizations.[1] The facts and circumstances of each particular audit will govern the appropriate form of report. This chapter discusses the application of SAS No. 58 to reports on the financial statements of not-for-profit organizations in specific circumstances.

**14.02** The auditor's standard report described in SAS No. 58 refers to "results of operations," which is usually understood to refer to an enterprise's net income for a period together with other changes in net worth. As described in chapter 3, "Basic Financial Statements," of this Audit and Accounting Guide (Guide), a not-for-profit organization's statement of activities reports the changes in net assets[2] for the period but does not purport to present the results of operations, as would an income statement of a for-profit organization.[3] Accordingly, the opinion paragraph of the auditor's report should refer to "changes in net assets," since that is more descriptive of the information in the statement of activities than "results of operations." Auditors should not report separately on operations if the statement of activities includes an intermediate measure of operations.

## Reports on Comparative Financial Statements

**14.03** As noted in chapter 3 of this Guide, not-for-profit organizations sometimes present comparative information for a prior year or years only in total rather than by net asset class. If reporting on comparative financial statements, the auditor should consider paragraph 74 of SAS No. 58, which states the following:

> The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor should update his report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.

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[1] In December 1995, the Auditing Standards Board issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, which amends SAS No. 58 by eliminating the requirement that, when certain criteria are met, the auditor add an uncertainties paragraph to the auditor's report.

[2] As discussed in paragraph 3.08, descriptive terms such as "change in equity" may be used.

[3] As discussed in chapter 3 of this Guide, a not-for-profit organization may present an intermediate measure of operations within the statement of activities. As noted in chapter 3, however, if an intermediate measure of operations is reported, it must be in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period. Such a statement would, therefore, ordinarily present more than merely the "results of operations"

Footnote 27 to paragraph 74 of SAS No. 58 states the following:

> A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units and not-for-profit organizations frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund, or the auditor would need to modify his report.

**14.04** Though Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, does not require fund reporting, it does require, however, that certain basic information, such as reporting net assets and changes in net assets by net asset class, be provided. If the prior year(s) financial statements include the minimum information required by FASB Statement No. 117 and this Guide, the financial statements are not summarized information. Accordingly, the auditor should report on them.

**14.05** As noted in paragraph 3.20, if the comparative financial information is summarized and does not include the minimum information required by FASB Statement No. 117 and this Guide—for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class—certain disclosures about the nature of the information presented are required. If the required disclosures about the nature of that information are omitted or are incomplete, the auditor ordinarily should add a paragraph to his or her report calling the omitted or incomplete disclosure to the readers' attention. Such a paragraph might include the same wording that appears in the illustrative note presented as an example in paragraph 3.21 of this Guide. To reduce the likelihood that a reader might misinterpret such a paragraph to be a qualified opinion on the current period financial statements, the paragraph should follow the opinion paragraph and should not be referred to in either the scope or opinion paragraphs of the auditor's report.

## Unqualified Opinions

**14.06** The auditor's standard report contains an opinion that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). That conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The form of the auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying statement of financial position of XYZ Not-for-Profit Organization as of September 30, 19XX, and the related statements of activities and cash flows for the year then ended.[4] These financial

[4] Each of the statements presented, which may include a statement of functional expenses, should be identified in the introductory paragraph.

statements are the responsibility of XYZ Not-for-Profit Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 19XX, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

## Modified Reports and Departures From Unqualified Opinions

**14.07** SAS No. 58, as amended by SAS No. 79, indicates the circumstances in which an explanatory paragraph should be added following the standard opinion paragraph for changes in accounting principles or in their method of application that have a material effect on the comparability of financial statements. The Statement also provides examples of auditors' reports in these circumstances. In addition, SAS No. 58 indicates circumstances in which departures from GAAP and limitations on the scope of the audit would require a qualified opinion, an adverse opinion, and a disclaimer of opinion, and provides examples of auditors' reports in those circumstances. Examples of possible departures from GAAP that an auditor of a not-for-profit organization's financial statements might encounter include the organization's failure to (*a*) recognize or appropriately measure promises to give, contributed services, or depreciation on plant and equipment in conformity with GAAP, and (*b*) provide information about expenses reported by their functional classification. The auditor's inability to obtain sufficient competent evidential matter to audit (*a*) contributed services that the organization has recorded or (*b*) receivables and revenues from fund-raising activities is an example of possible restrictions on the scope of the audit that an auditor of a not-for-profit organization's financial statements might encounter.

**14.08** SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended by SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as Going Concern, *and No. 62,* Special Reports, indicates circumstances in which an explanatory paragraph should be added following the standard opinion paragraph because the auditor has substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the balance sheet. SAS No. 59 also provides guidance on reporting in that situation, including an example of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern. Paragraph 2.47 of this Guide contains examples of conditions or events that are particularly applicable to not-for-profit organizations and that might indicate that there could be substantial doubt about the organization's continued existence.

## Reporting on Supplementary Information

**14.09** Footnote 6 to paragraph 27 of FASB Statement No. 117 states the following:

> Information about an organization's major programs (or segments) can be enhanced by reporting the interrelationships of program expenses and program revenues.... Related nonmonetary information about program inputs, outputs, and results also is helpful.... Generally, reporting that kind of information is feasible only in supplementary information or management explanations or by other methods of financial reporting.

**14.10** Although nonmonetary information about an organization's activities and programs may be informative and helpful to users of the financial statements, this information is not necessary for fair presentation of financial position, changes in net assets, or cash flows on which the auditor is reporting. In addition, this information may not be auditable if it is obtained from records outside the accounting system that are not subject to controls, rather than being obtained (or derived by analysis or computation) from records subject to controls. Accordingly, this information should not be included in the financial statements (including the related notes) unless it is obtained from the organization's accounting records that are subject to controls over the organization's accounting system or derived directly from such accounting records by analysis or computation. Paragraph 46 of SAS No. 58 suggests that if information that is not audited and is not necessary for a fair presentation is included in the financial statements (including the related notes), such information may be identified as *unaudited* or *as not covered by the auditor's report*, in which case the auditor should not comment on it or otherwise be associated with it.

## Bases of Accounting Other Than GAAP

**14.11** Some not-for-profit organizations may find that financial statements prepared on the cash basis or the modified cash basis of accounting are adequate for their governing boards and other users. SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), describes the auditor's reporting requirements when the financial statements are prepared on a comprehensive basis of accounting other than GAAP (OCBOA), including the cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support.[5]

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[5] The accrual basis of accounting is required by GAAP for a fair presentation of financial position, changes in net assets, and cash flows. Financial statements presented on the cash receipts and disbursements basis of accounting or using modifications of the cash basis having substantial support may be considered to present financial position, changes in net assets, and cash flows in conformity with GAAP only if they do not differ materially from financial statements prepared on an accrual basis.

**14.12** SAS No. 62 also permits an auditor to issue a special report on financial statements that have been prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency but that do not conform with GAAP or constitute OCBOA. In that instance, the auditor's report should include a paragraph that restricts the distribution of the report solely to persons within the organization and for filing with the regulatory agency. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may use this form of report, however, only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the organization is subject.

## Reporting on Prescribed Forms

**14.13** Some not-for-profit organizations prepare financial reports using forms prescribed by an affiliated organization. The auditor should review these forms and any accompanying preprinted auditor's report for compliance with GAAP and GAAS. If the financial statements prepared using the prescribed form do not conform with GAAP, either the auditor can attach a separate set of financial statements and report on them, or he or she can issue a report on the prescribed form but include a restriction on its distribution, as discussed above. If the auditor considers the preprinted auditor's report inappropriate, he or she should prepare a separate report. When a separate report is used, the auditor should consider inserting language such as "See attached independent auditor's report" in the space provided for the auditor's signature on the preprinted form.

**14.14** Internal Revenue Service (IRS) Form 990, *Return of Organizations Exempt from Income Tax*, may be used in some states as an annual report by not-for-profit organizations for reporting to both state and federal governments. Many states require an auditor's opinion on the financial statements included in an IRS Form 990. An auditing interpretation of SAS No. 62 titled "Reports on the Financial Statements Included in Internal Revenue Form 990, 'Return of Organizations Exempt from Income Tax'" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.47–.54), provides guidance on reporting on financial statements included in Form 990. (Paragraph 54 of that Interpretation may no longer be relevant as a result of the issuance of FASB Statement Nos. 116 and 117.)

## Reports Required by *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and OMB Circular A-133

**14.15** *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and U.S. Office of Management and Budget (OMB) Circular A-133 broaden the auditor's responsibility to include reporting on not only an organization's financial statements but also its internal control and its compliance with laws and regulations. Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*,[6] describes and illustrates the required reports.

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[6] SOP 92-9 is included as appendix B of this Guide (see footnotes 2 and 8 in chapter 2 of this Guide).

# Chapter 15
# Tax Considerations

## Introduction

**15.01** This chapter discusses certain tax considerations relevant to not-for-profit organizations. It does not contain a detailed discussion of the Internal Revenue Code (IRC) and of rulings that have been issued by the Internal Revenue Service (IRS) and that apply to not-for-profit organizations, nor is it intended as a substitute for appropriate research in resolving tax issues.

**15.02** Not-for-profit organizations and their auditors should be aware of relevant federal and state tax laws and regulations and their potential impact on the organization and its financial statements. An organization's failure to maintain its tax-exempt status could have serious tax consequences and affect both its financial statements and related disclosures, and it could possibly require modification of the auditor's report. Failure to comply with tax laws and regulations could be an illegal act that may, as discussed in chapter 2, "General Auditing Considerations," of this Audit and Accounting Guide (Guide), have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).

## Basis of Exemption

**15.03** The IRS determines whether an organization qualifies for exemption from federal income tax. The following are some of the more common types of tax-exempt organizations:

- Corporations, united funds, other funds, and foundations organized and operated (*a*) exclusively for religious, charitable, scientific, testing-for-public-safety, literary, or educational purposes, (*b*) to foster national or international amateur sports competition, or (*c*) for the prevention of cruelty to children or animals
- Civic leagues, organizations operated exclusively for the promotion of social welfare, and certain local associations of employees
- Labor, agricultural, and horticultural organizations
- Business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues, that are not organized for profit
- Clubs organized for pleasure, recreation, and other not-for-profit purposes

**15.04** Exemptions from state and local sales, real estate, and other taxes vary from state to state. Organizations are generally subject to the laws of the state of incorporation as well as the laws of states in which they conduct significant activities. Each state's laws govern exemption from its taxes and should be consulted for the applicable definitions and requirements.

**15.05** Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke exemptions for any one of several reasons. Furthermore, individual states have regulatory bodies that oversee not-for-profit organizations and that can revoke their state tax-exempt status without regard to their federal tax-exempt status and even prevent them from operating. There are many potential threats to an organization's federal tax-exempt status, of which the following are particularly important:

- Material changes in the organization's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying
- Political campaign activities
- Unrelated business income
- Failure of the organization to meet the commensurate test
- Violation of public policy by the organization

**15.06** The IRS requires that organizations disclose on Form 990 any changes in the kinds of exempt activities the organization conducts, any changes in its governing documents, and whether there has been a liquidation, dissolution, or substantial contraction. If there has been a material change in the organization's character, purpose, or method of operation, it may be appropriate to seek IRS guidance in the form of a private letter ruling.

**15.07** Not-for-profit organizations are generally prohibited from making distributions to those who control or support them financially. IRS rules regulate transactions between a not-for-profit organization and insiders. IRC provisions concerning such transactions are stricter for private foundations than for other not-for-profit organizations. Insiders are individuals with a personal or private interest in the organization, such as governing board members, officers, certain employees, and substantial contributors. Transactions between insiders and not-for-profit organizations are permitted, but the organization has the burden of proving that the transactions do not result in private inurement. The organization must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be "unreasonably high."

**15.08** The concept of private benefit prohibits a not-for-profit organization from providing excessive benefits for the private interests of any specific individual or group—both insiders and outsiders. Incidental levels of private benefits are permitted, but the organization is required to demonstrate that such benefits are a necessary concomitant of a public related benefit. The organization should have sound policies for transactions with both insiders and outsiders, and these policies should document that the transactions were appropriate and were approved by disinterested parties.

**15.09** A not-for-profit organization cannot qualify for tax exemption, or can have its tax-exempt status revoked, if it is, in reality, a commercial enterprise. Engaging in commercial activity, however, does not *per se* disqualify the organization from tax-exempt status unless the commercial activity becomes the organization's primary purpose. A gray area exists between commercial and noncommercial activities. To avoid problems with commerciality, many not-for-profit organizations have found it advantageous to create separate for-profit subsidiaries.

**15.10** The IRC allows public charities (but not private foundations) to lobby to influence federal, state, and local legislation (including initiatives and referenda), but it places limits on how much lobbying they can do. Membership organizations that are granted tax-exempt status under IRC Section 501(c)(4)(5) or (6) and lobby are required to make complex disclosures to their members or pay a proxy tax.

**15.11** Public charities are prohibited from engaging in partisan political campaign activities. Prohibited political activities include contributing to candidates or political organizations, including, for example, in-kind contributions of services, publicity, advertising, paid staff time, facilities, and office space. Also prohibited are evaluating candidates and their positions on specific issues and encouraging voter registration for a specific political group. Permitted political activities include nonpartisan get-out-the-vote campaigns.

**15.12** Not-for-profit organizations can lose their tax-exempt status if the IRS determines that too large a percentage of their income is from business activities unrelated to their specific exempt purposes. There is, however, no specific percentage of unrelated business income that can be designated as too large a percentage and is, therefore, not permissible. The facts and circumstances of each unrelated business income situation should be considered. Unrelated business income and the unrelated business income tax are discussed in more detail in paragraphs 15.17 through 15.19.

**15.13** A not-for-profit organization can lose its tax-exempt status if it fails the commensurate test, which provides that the scope of the organization's programs must be commensurate with its financial resources. The test requires that an organization have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial. This means that fund-raising expenses and administrative expenses should not be an excessive percentage of total expenses. Although no specific payout percentage has been established and individual facts and circumstances must be considered, low levels of program spending invite IRS scrutiny.

**15.14** An organization can also lose its tax exemption because it violates public policy, for example, through racial discrimination.

## Federal and State Filing Requirements

**15.15** Most tax-exempt organizations, except those with less than $25,000 in gross receipts or churches, must file annual information returns with the IRS. Most states also have their own registration and filing requirements, some of which include audited financial statements. The auditor should be aware of specific state laws and regulations that specify filing and reporting requirements, but except for the discussion of related auditors' reports in chapter 14, "Reports of Independent Auditors," of this Guide, these are beyond the scope of this Guide.

## Public Charities and Private Foundations

**15.16** The IRS considers all charitable organizations (that is, those that are tax-exempt under IRC Section 501(c)(3)) to be private foundations unless they qualify as public charities (sometimes referred to as *nonprivate foundations*) under one of several IRC tests. Private foundations are subject to more restrictions under the tax law than are public charities. These restrictions include statutory prohibitions against self-dealing, excess business holdings, jeopardy investments, and taxable expenditures. In addition, private foundations are subject to an excise tax on their net investment income and are required to make annual distributions of five percent of the average market value of their noncharitable-use assets for charitable, educational, scientific, and similar purposes. (Noncharitable-use assets are assets that are not used or held for use directly in carrying on the organization's exempt purpose; they include assets held for investment and the production of investment income.) Private foundations are also required to publish annually a notice that their annual reports are available for inspection. Public charities are exempt from federal unemployment taxes. Both public charities and private foundations may be exempt from property and sales taxes in some states.

## Unrelated Business Income

**15.17** Unrelated business income is gross income from an unrelated trade or business less expenses "directly connected" with the unrelated trade or business, certain net operating losses, and qualified charitable contributions. An unrelated trade or business of an exempt organization is any trade or business which is regularly carried on, and whose conduct is not substantially related to the exercise or performance of its exempt purpose. The IRS is primarily interested in how the unrelated business income was earned, not in how it is used, even if it is used to further the organization's tax-exempt purpose. Unrelated business income is subject to federal corporate taxes on income, including the alternative minimum tax (AMT). (The first $1,000 of net unrelated business income is excluded from taxation, and corporate net operating losses and various tax credits are allowed.)

**15.18** The unrelated-business-income tax requirements apply to all not-for-profit organizations except (*a*) corporations that have been organized under Acts of Congress and that are instrumentalities of the United States and (*b*) certain charitable trusts not subject to the tax on private foundations.

**15.19** Income from certain specified activities that might otherwise be considered unrelated business income is excluded from taxation. For example, unrelated business income does not include dividends, interest, royalties, and gains on the sale of property (unless that property was used in an unrelated trade or business). Unrelated business income also does not include income from activities in which substantially all of the work is done by volunteers, income from the sale of donated merchandise, and rents from real property. However, rents from debt-financed property, rents based on a percentage of net income rather than gross income, and rents on personal property are considered to be unrelated business income.

## Auditing

**15.20** As previously discussed, noncompliance with federal and state tax laws and regulations may have direct and material effects on an organization's financial statements. Noncompliance may also, possibly through the loss of the organization's tax-exempt status, have indirect effects on the statements. Since many organizations depend on their tax-exempt status for funding purposes and could lose their funding if that status was revoked, such indirect effects may also indicate that there is substantial doubt about the organization's ability to continue as a going concern.

**15.21** Many audit objectives, controls, and auditing procedures for the tax provisions and liabilities of not-for-profit organizations are similar to those of other organizations. In addition, the auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures that are unique to not-for-profit organizations.

## Auditing Considerations

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| Rights and obligations | The not-for-profit organization has obtained qualifying tax exemptions from the appropriate government authorities. | Management monitors compliance with applicable tax regulations. | Ascertain whether the organization has been granted tax-exempt status.<br><br>Review minutes of governing board meetings for changes in the organization's governing instruments that could affect its tax-exempt status.<br><br>Consider the effect of new, expanded, or unusual activities on the organization's tax-exempt status. |
| Completeness | All liabilities and contingencies for taxes due for the current and prior years are accrued or disclosed. | Tax returns are prepared and reviewed by knowledgeable personnel. | Inquire if tax returns have been filed on a timely basis.<br><br>Review tax returns or filings and related correspondence for all "open" years.<br><br>Review revenue agent's reports, if any, for evidence of additional liabilities or contingencies. |

| *Financial Statement Assertions* | *Specific Audit Objectives* | *Examples of Selected Controls* | *Examples of Auditing Procedures* |
|---|---|---|---|
| | | | Review minutes of governing board and governing board committee meetings and the accounting records for evidence of significant unrelated business income. |
| | | | Review the reasonableness of the computation of any unrelated business income tax liability. |
| Presentation and disclosure | The organization's tax-exempt status and any tax contingencies are disclosed in the notes to the financial statements. | | Determine whether the organization's tax-exempt status and any tax contingencies are appropriately disclosed in the notes to the financial statements. |

# Chapter 16

# *Fund Accounting*

## Introduction

**16.01** Many not-for-profit organizations have used fund accounting both for internal recordkeeping and for external financial reporting purposes. Fund accounting segregates assets, liabilities, and fund balances into separate accounting entities associated with specific activities, donor-imposed restrictions, or objectives. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, however, establishes a financial reporting model based on net assets, classified solely on the basis of donor-imposed restrictions, and requires not-for-profit organizations' external financial reporting to focus on aggregate information about the entity as a whole, rather than on individual funds.[1] Though fund accounting is not required by generally accepted accounting principles, some entities will continue to use fund accounting for internal recordkeeping purposes. Also, FASB Statement No. 117 and this Audit and Accounting Guide (Guide) permit the continued disclosure, for external financial reporting purposes, of disaggregated data classified by fund groups, provided that the information required by FASB Statement No. 117 and this Guide is presented. This chapter provides an overview of fund accounting and discusses the reporting of information derived from an internal fund accounting system in conformity with the reporting requirements of the net asset model.[2, 3]

## Fund Accounting and External Financial Reporting

**16.02** Fund accounting is a system of recording resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law. To keep records of these limitations for internal purposes, some not-for-profit organizations maintain separate funds for specific purposes. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts. Before the issuance of FASB Statement No. 117, most not-for-profit organizations prepared fund-accounting-based external financial statements by combining funds with similar characteristics into fund groups. Authoritative guidance for external financial reporting was provided by the two AICPA industry audit guides, one audit and accounting guide, and two of the Statements of Position (SOPs) that are superseded by this Guide.[4]

[1] Both fund balances and net assets represent residual interests in assets less liabilities. Fund balances, however, are not the same as net asset balances.

[2] The discussion in this chapter assumes that the provisions of paragraph 17 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, concerning the recognition of expirations of donor-imposed restrictions are applied prospectively, in conformity with paragraph 30 of Statement No. 116.

[3] The timing of recognition of changes in net assets under fund accounting and the net asset model may differ. For example, restrictions may expire under the net asset model in different periods than when expenses are reported in a fund. Accordingly, not-for-profit organizations that continue to use fund accounting for internal recordkeeping purposes should keep records of all transactions and events that have been recognized under one model but not the other and should adjust opening fund accounting balances to amounts representing opening net assets.

[4] As noted in the preface, this Guide supersedes *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities* (including SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*) and *Audits of Certain Nonprofit Organizations* (including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*).

**16.03** For external financial reporting purposes, the total of all assets and liabilities included in all funds and changes in net assets should be measured and reported on a not-for-profit organization's financial statements in conformity with FASB Statement Nos. 116 and 117 and with chapters 3 through 13 of this Guide. (As stated in footnote 8 of Statement No. 117, "because receivables and payables between fund groups are not organizational assets or liabilities, a statement of financial position must clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.") Fund balances should be classified on a statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the existence and type of donor-imposed restrictions.[5] For external financial reporting purposes, a fund balance may have to be divided among more than one net asset class. The remainder of this chapter describes seven commonly used kinds of funds and discusses how their fund balances should be reported based on the requirements of FASB Statement No. 117 and this Guide.

## Unrestricted Current (or Unrestricted Operating or General) Funds

**16.04** Unrestricted current funds (also called *unrestricted operating* or *general* funds) are used to record organizations' activities that are supported by resources over which governing boards have discretionary control. Amounts designated by governing boards for specific purposes may be included in unrestricted current funds, or those amounts may be accounted for in other funds, such as plant funds, endowment funds, and loan funds. The principal sources of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers, and others; and unrestricted investment income. Resources are used to help meet the costs of providing the organization's programs and supporting services.

**16.05** Fund balances of unrestricted current funds should be classified on a statement of financial position as unrestricted net assets unless donors have stipulated restrictions on the use of contributed assets that expire by passage of time. In those situations, net assets should be classified as temporarily restricted. Unrestricted fund balances that have been designated by governing bodies for specific purposes (such as *quasi-endowment*, *funds functioning as endowment*, *funds for long-term investment*, *self-insurance reserve funds*, or *future development funds*) should be classified as unrestricted net assets. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.12 of this Guide.

## Restricted Current (or Restricted Operating or Specific-Purpose) Funds

**16.06** Restricted current funds (also called *restricted operating* or *specific-purpose* funds) are used to record organizations' activities that are supported by resources whose use is limited by external parties to specific operating purposes. The principal sources of restricted current funds are contributions

[5] Accounting for contributions received with donor-imposed restrictions is discussed in paragraphs 5.26 through 5.34 of this Guide.

from donors; contracts, grants and appropriations; endowment income; and other sources where resource providers have stipulated the specific operating purposes for which the resources are to be used.

**16.07** Fund balances of restricted current funds represent net assets held for specified operating activities that have not yet been used. The portion of the fund balances, if any, that represents amounts contributed with donor-imposed restrictions should be classified as temporarily restricted net assets. Fund balances representing amounts received with limitations other than donor-imposed restrictions, such as contractual limitations, should be classified as unrestricted net assets. Any portion of the fund balances that represents unearned revenue resulting from exchange transactions should be classified as a liability.

## Plant (or Land, Building, and Equipment) Funds

**16.08** Some not-for-profit organizations record plant and equipment (and resources held to acquire them) in a plant (or land, building, and equipment) fund or funds. A plant fund may be a single group of accounts or may be subdivided into some or all of the following subfund account groups:

- Unexpended plant funds
- Funds for renewal and replacement
- Funds for retirement of indebtedness
- Investment (or net investment) in plant

**16.09** Unexpended plant fund balances and renewals and replacement fund balances represent net assets that have not yet been used to acquire, renew, and replace plant and equipment. Retirement-of-indebtedness fund balances represent net assets held to service debt related to the acquisition or construction of plant and equipment. The portion of those fund balances that represents amounts received with donor-imposed restrictions should be classified in a statement of financial position as temporarily restricted or permanently restricted net assets, depending on the nature of the restrictions. Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, construction, renewal, or replacement of property and equipment, should be classified as unrestricted net assets.[6]

**16.10** Investment-in-plant fund balances represent assets invested in property and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent that (1) donors have imposed restrictions on the assets' use that neither expire by passage of time nor can be fulfilled or removed by actions of the organization—for example, land that must be held in perpetuity—or (2) the proceeds from the ultimate sale or disposal of contributed assets must be reinvested in perpetuity. Amounts representing property and equipment donated or acquired with donor-imposed restrictions that expire by passage of time or that can be fulfilled or removed by actions of the organization should be classified as temporarily restricted net assets. Amounts representing gifts of property and equipment received without donor-imposed restrictions about how long the

[6] Board designations and other limitations on the use of unrestricted net assets stipulated by entities other than donors can be described on the face of the financial statements or in the notes. Paragraphs 3.07 and 11.12 of this Guide discuss such disclosures.

assets must be used should be classified as either unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.[7] Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets. Significant limitations on the use of property and equipment should be described in notes to the financial statements.[8]

## Loan Funds

**16.11** Some not-for-profit organizations use loan funds to account for loans made to students, employees, and other constituents and resources available for those purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. These organizations or individuals may also stipulate qualifications for individual borrowers. Some loan funds are self-perpetuating—that is, the principal and interest repayments on outstanding loans are used to make additional loans. Other loan funds are created on a temporary basis, and the original resource providers must be repaid. In some situations, repayments may be forgiven by resource providers if certain conditions are met.

**16.12** Fund balances of loan funds represent net assets available for lending. The portion of the fund balances representing net assets restricted by donors in perpetuity for use in making loans (for example, a revolving fund) should be classified as permanently restricted. The portion of the fund balances representing net assets temporarily restricted by donors (for example, if, each year, a portion of the fund may be used for the unrestricted purposes of the organization) should be classified as temporarily restricted. Amounts that have been designated by governing boards to be used as loan funds, such as amounts designated as matching funds for government loan programs (for example, government loans to students that require colleges and universities to match a portion of those loans) and other amounts used for loans that have not been restricted by donors, should be classified as unrestricted net assets. Any portion of loan fund balances that represents refundable advances, such as under a government loan program, should be reported as a liability.

## Endowment Funds

**16.13** Some not-for-profit organizations record cash, securities, or other assets held to provide income for the maintenance of the organization in an endowment fund or funds. Three kinds of endowment may be identified: permanent endowment; term endowment; and quasi endowment, or funds functioning as endowment. *Permanent endowment* refers to amounts that have been contributed with donor-specified restrictions that the principal be invested in perpetuity; income from those investments may also be restricted by donors. *Term endowment* is similar to permanent endowment, except that at some future time or upon the occurrence of a specified future event, the re-

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[7] Paragraph 9.05 of this Guide discusses alternative accounting policies concerning the contribution of long-lived assets received without donor-imposed restrictions.

[8] Examples of significant limitations on the use of property and equipment that should be described in the notes to the financial statements are provided in paragraph 9.15 of this Guide.

sources originally contributed become available for unrestricted or purpose-restricted use by the entity. *Quasi endowment* refers to resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.

**16.14** Fund balances of endowment funds represent net assets for which various limitations exist on the use of the resources invested and, in some cases, on the income generated by those resources. Amounts that represent net assets restricted by donors in perpetuity should be classified as permanently restricted. If donor-imposed restrictions exist that preclude the use of gains and losses (net appreciation) on permanent endowment, either as a result of explicit or implicit donor stipulation or by the organization's interpretation of the relevant law, those gains and losses should also be classified as permanently restricted. In the absence of such restrictions, those gains and losses should be classified as temporarily restricted or unrestricted, depending on the existence or absence of temporary restrictions imposed by the donor.

**16.15** Fund balances that represent term endowments for which the principal must be maintained for a specific period or must be used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Amounts representing resources that will be permanently restricted at the end of a specified term should be classified as permanently restricted net assets.

**16.16** Fund balances that represent quasi endowments or other amounts designated by the organization's governing board should be classified as unrestricted net assets unless donor-imposed restrictions exist on their use. Board designations are permitted to be disclosed, as discussed in paragraphs 3.07 and 11.12 of this Guide.

## Annuity and Life-Income (Split-Interest) Funds

**16.17** Annuity and life-income (or split-interest) funds may be used by not-for-profit organizations to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest in the resources but is not the sole beneficiary. These agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. Split-interest agreements are discussed in chapter 6, "Split-Interest Agreements," of this Guide.

**16.18** Fund balances of annuity and life-income funds represent a not-for-profit organization's beneficial interest in the resources contributed by donors under split-interest agreements. Any portion of the fund balances representing amounts that will become part of permanent endowment when the agreements terminate should be classified as permanently restricted net assets. Any portion of the fund balances representing amounts that will be available for restricted purposes, or available for unrestricted use, by the entity when agreements terminate should be classified as temporarily restricted net assets. Any portion of the fund balances representing amounts that are available for unrestricted purposes should be classified as unrestricted net assets.

## Agency (Or Custodian) Funds

**16.19** Agency (or custodian) funds are used by not-for-profit organizations to account for resources held by the entity as an agent for resource providers before those resources are transferred to third-party recipients specified by the resource providers. The entity has little or no discretion over the use of those resources. Accounting for agency transactions and distinguishing agency transactions from contributions are discussed in chapter 5, "Contributions Received and Agency Transactions," of this Guide. Because the assets and liabilities are always equal in agency funds, no net assets are reported.

## Summary

**16.20** The following exhibit summarizes the net asset classes into which various kinds of fund balances will typically be classified.

## Typical Classification of Fund Balances

| | *Net Asset Class* | | |
|---|---|---|---|
| *Fund Type* | *Permanently Restricted* | *Temporarily Restricted* | *Unrestricted* |
| Unrestricted Current (or Unrestricted Operating or General) | Not applicable | Contributions with donor-imposed restrictions that expire with the passage of time (not usually present in unrestricted current funds) | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Restricted Current (or Restricted Operating or Specific Purpose) | Not applicable | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization | Unrestricted fund balances, including those designated by governing bodies for specific purposes[9] |
| Plant (or Land, Building, and Equipment) | Contributions with donor-imposed restrictions that do not expire with the passage of time or cannot be fulfilled or removed by actions of the organization[10] | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization[11] | Unrestricted fund balances, including those designated by governing bodies for specific purposes[12] |

[9] Any portion of the fund balances representing unearned revenue from exchange transactions should be classified as a liability.

[10] This would include contributed assets such as land and capitalized collection items that must be held in perpetuity and other contributed assets when donors have stipulated that the proceeds from their ultimate sale or disposal must be reinvested in perpetuity.

[11] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

[12] Amounts representing assets contributed without donor-imposed restrictions about how long the land, building, or equipment must be used should be classified as unrestricted or temporarily restricted net assets, depending on the accounting policy adopted by the organization.

| *Fund Type* | *Permanently Restricted* | *Temporarily Restricted* | *Unrestricted* |
|---|---|---|---|
| Loan | Contributions with donor-imposed restrictions that do not expire with the passage of time or can not be fulfilled or removed by actions of the organization | Contributions with donor-imposed restrictions that expire with the passage of time or that can be fulfilled or removed by actions of the organization | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Endowment | Permanent endowment[13] | Temporary (or term) endowment[14] | Quasi endowment[15] |
| Annuity and Life-Income (Split Interests) | Donor-restricted in perpetuity | Amounts available for unrestricted or time-or-purpose restricted use when agreement terminates | Unrestricted fund balances, including those designated by governing bodies for specific purposes |
| Agency (or Custodian) | Not applicable | Not applicable | Not applicable |

[13] Includes gains and losses on permanent endowment when donor restrictions or law permanently preclude their use.

[14] Includes gains on permanent endowment when donor restrictions or law specify their use.

[15] Includes gains on permanent endowment when donors or laws do not restrict or specify their use.

# Appendix A

# *Background Information and Basis for Conclusions*

**1.** This appendix provides background information and discusses the comments received on the April 14, 1995, exposure draft that preceded this Audit and Accounting Guide (Guide)—Proposed Audit and Accounting Guide *Not-for-Profit Organizations*—and the basis for key conclusions in this Guide.

## Background

**2.** In June 1993, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, and Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. At the time those Statement were issued, guidance on accounting and reporting by not-for-profit organizations was provided by the following AICPA pronouncements:

- Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide *Audits of Colleges and Universities*, including Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*, including SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Some of the guidance in those AICPA pronouncements was inconsistent with FASB Statement Nos. 116 and 117.

**3.** In light of the comprehensive changes in generally accepted accounting principles (GAAP) for not-for-profit organizations resulting from guidance in FASB Statement Nos. 116 and 117, as well as changes in practice that have occurred subsequent to the issuance of the pronouncements that this Guide supersedes, the AICPA's Accounting Standards Executive Committee (AcSEC) and the Not-for-Profit Organizations Committee (the Committees) concluded that the AICPA guidance should be completely rewritten, rather than merely revised for conforming changes based on the issuance of Statement Nos. 116 and 117.

**4.** FASB Statement Nos. 116 and 117 provide broad, rather than industry-specific, guidance for the various kinds of not-for-profit organizations. By providing broad guidance directed at critical issues, FASB Statement Nos. 116 and 117 allow organizations latitude to report relevant information in ways they believe are most useful to financial statements users. Paragraphs 3 and 49 of FASB Statement No. 117 specify that, within the parameters of that Statement, the AICPA may provide more specific reporting guidance for certain not-for-profit organizations.

**5.** In light of the broad standards included in FASB Statement Nos. 116 and 117 and the belief that like transactions should be accounted for in like ways, regardless of the industry in which the organization operates, the Committees believe that this Guide should apply to all not-for-profit organizations. Further, this Guide should include guidance that is applied consistently by different kinds of not-for-profit organizations, rather than guidance that differs based on the kind of not-for-profit organization, such as voluntary health and welfare organizations or private colleges and universities.[1] Accordingly, this Guide is directed at not-for-profit organizations in general and not at specific kinds of such organizations.

## Discussion of Comment Letters and Basis for Conclusions

6. In April 1995, the Committees released an exposure draft of a proposed Audit and Accounting Guide *Not-for-Profit Organizations* for public comment. The Committees received 160 comment letters on the exposure draft. The Committees redeliberated the issues based on the comments received. The following is a discussion of the key issues in the exposure draft and comments received on those issues, as well as the basis for the Committees' conclusions on those and certain other issues.

### Scope

7. The exposure draft proposed that some organizations that have traditionally been considered to be not-for-profit organizations do not meet the definition of a not-for-profit organization in FASB Statement No. 116. The exposure draft noted that, though FASB Statement No. 117 excludes those organizations from its scope, it contains broad guidelines that would enable them to prepare meaningful financial statements. Accordingly, the exposure draft proposed that, with certain limited exceptions, the Guide apply to nongovernmental organizations of the kinds that have traditionally been considered to be not-for-profit organizations, such as certain social clubs and trade associations, unless they are organized for for-profit purposes, regardless of whether a particular organization meets the definition of a not-for-profit organization in FASB Statement No. 116. Also, the exposure draft noted that certain FASB and other pronouncements apply to organizations other than those that meet the FASB Statement No. 116 definition of a not-for-profit organization (those pronouncements exempt not-for-profit organizations). Accordingly, the exposure draft noted that organizations that do not meet the FASB Statement No. 116 definition of a not-for-profit organization, regardless of whether they are within the scope of this Guide, are required to follow GAAP applicable to for-profit entities, such as FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Some respondents commented that the Guide should revise or clarify the definition of a not-for-profit organization. The Committees believe that the intent of the FASB in drafting the definition in Statement No. 116 was that the term *not-for-profit organizations* encompasses all entities defined as *not-for-profit organizations* by FASB Statement No. 116, including the kinds of organizations that were

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[1] At the same time that AcSEC undertook this project, AcSEC and the Health Care Committee undertook a project to revise the Audit and Accounting Guide *Audits of Providers of Health Care Services*. The guidance in that revised Guide, *Health Care Organizations*, applies to health care providers that are not-for-profit organizations, as well as to for-profit and governmental health care providers. AcSEC believes that comparability among health care providers is more important than comparability between not-for-profit health care providers and other kinds of not-for-profit organizations. Accordingly, this Guide does not include guidance for not-for-profit health care providers. However, the guidance in *Health Care Organizations* for not-for-profit health care organizations is similar to the guidance in this Guide for other not-for-profit organizations, unless differences are justified for purposes of comparability among health care providers.

covered by the AICPA pronouncements that are superseded by this Guide. Further, the Committees believe that the guidance proposed in the exposure draft could create practice problems for entities for which it may be unclear whether they meet that definition. Accordingly, the Guide has been revised to provide that the term *not-for-profit organizations* includes the kinds of organizations that were covered by the AICPA pronouncements that are superseded by this Guide.

### *Nongovernmental Not-for-Profit Organizations*

**8.** As noted in paragraph 7 of this appendix, the exposure draft proposed that the Guide apply to certain kinds of nongovernmental organizations. However, the exposure draft did not define *nongovernmental* and did not include guidance to help identify nongovernmental organizations. Some respondents commented that the Guide should define *nongovernmental*. They pointed out that AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), establishes separate hierarchies of sources of GAAP for nongovernmental and governmental entities and that there is diversity in practice concerning how entities are determined to be *nongovernmental*.

**9.** Subsequent to the release of the exposure draft, during a public meeting in which they cleared the proposed Audit and Accounting Guide *Health Care Organizations* for final issuance, the FASB and the Governmental Accounting Standards Board agreed on the definition of a *government*. Accordingly, this Guide incorporates that definition and defines *nongovernment entities* as all entities not meeting the definition of a *government*.

## GAAP Hierarchy

**10.** Paragraph 1.12 of the Guide states that not-for-profit organizations should follow the display guidance in FASB Statement No. 117 and this Guide, even though that guidance may conflict with display that would result from applying the guidance in certain pronouncements included in appendix D [paragraph 1.27] of chapter 1, "Introduction," of this Guide. (The guidance in appendix D [paragraph 1.27] is included in category (a) of the GAAP hierarchy and is a higher category of GAAP than this Guide, as discussed in appendix G [paragraph 1.30] of chapter 1.) Paragraph 1.12 does not imply that guidance in this Guide is a higher category of GAAP than guidance in category (a). Paragraph 1.12 merely addresses the fact that not-for-profit organizations use a financial reporting display model that differs from the model used by for-profit entities and that the not-for-profit model may not have been contemplated in developing the guidance in some category (a) pronouncements.

## Operations

**11.** The exposure draft proposed that "[i]f an intermediate measure of operations is reported, revenues and expenses that are an integral part of an organization's programs or mission and supporting activities should be included in that measure. Expenses related to revenues included in an intermediate measure of operations should also be included in that measure." Some respondents commented that that guidance is more restrictive than the guidance in FASB Statement No. 117 and should be deleted because it would result in unnecessary changes in practice. The Committees agreed and therefore concluded that that guidance should be deleted.

## Reporting Expenses

12. FASB Statement No. 117 requires that the statement of activities report the gross amounts of revenues and expenses. However, FASB Statement No. 117 permits an exception for investment expenses, such as custodial fees and investment advisory fees, which may be netted against investment revenues, provided that the amount of the expenses is disclosed either on the face of the statement of activities or in the notes to financial statements. In addition, FASB Statement No. 117 provides that voluntary health and welfare organizations should report expenses by their functional and natural classifications in a matrix format, because that information is meaningful to users of voluntary health and welfare organizations' financial statements. Further, FASB Statement No. 117 encourages other not-for-profit organizations to provide information about expenses by their natural classification. The Committees considered whether expenses that are netted against investment revenues should be reported by their functional classification on the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format if the organization presents that statement. Similarly, the Committees considered whether the natural classification of expenses that are reported by other than their natural classification, such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors, should be reported by their natural classification if information about expenses reported by their natural classification is presented. The Committees believe that permitting those expenses to be reported as other than by their natural classification defeats the purpose of reporting information about expenses by their natural classification and makes such presentations incomplete. In particular, the Committees considered circumstances in which investment expenses or cost of sales include significant payroll and payroll related expenses. The Committees believe that that information is useful to those financial statement users and that it should be required to be reported in circumstances in which the separate statement that reports information about expenses by their natural classification as well as by their functional classification in a matrix format is presented.

## Economic Interest

13. SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, provides that a not-for-profit organization should consolidate another not-for-profit organization if the reporting organization has certain kinds of control and an economic interest. The SOP provides that an economic interest is "an interest in another entity that exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (*b*) the reporting organization is responsible for the liabilities of the other entity." The SOP provides examples of economic interests. Subsequent to issuing the SOP, questions arose concerning whether a not-for-profit organization has an economic interest in another entity if the organization has a right to or a responsibility for the operating results of another entity or, upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity. The Committees believe that such circumstances result in an economic interest under the definition in the SOP. Accordingly, in applying the guidance in SOP 94-3, not-for-profit organizations should consider the example of an economic interest included in this Guide.

## Noncompliance With Donor-Imposed Restrictions

**14.** In some circumstances, a not-for-profit organization may not be in compliance with donor-imposed restrictions, including requirements that it maintain an appropriate composition of assets (usually cash and marketable securities in amounts needed to comply with all donor restrictions). In their May 7, 1992, letter responding to a request by the FASB about the adequacy of existing accounting and auditing standards, the AICPA's Not-for-Profit Organizations Committee and Not-for-Profit Organizations Guide Task Force said:

> We believe [FASB Statement No. 5, *Accounting for Contingencies*, SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)] require that noncompliance with donor-imposed restrictions be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue, or cause an entity not to be able to continue as a going concern. Such noncompliance could result in a material contingent liability, result in a material loss of future revenue, or cause the organization to be unable to continue as a going concern.

The Committees agree with the conclusions expressed in the May 7, 1992 letter. Accordingly, the Guide provides that noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern.

## Agency Transactions

**15.** The exposure draft, primarily chapter 5, "Contributions Received and Agency Transactions," of this Guide, included proposed guidance concerning reporting agency transactions. In addition, the letter transmitting the exposure draft specifically requested comments on issues related to variance power and donor-advised provisions. Some of the guidance included in the exposure draft, as well as tentative conclusions reached during the Committees' deliberations concerning issues related to variance power and donor-advised provisions, was more detailed than the guidance concerning agency transactions included in FASB Statement No. 116. In December 1995, the FASB released an exposure draft of a proposed Interpretation of FASB Statement No. 116, *Transfers of Assets in Which a Not-for-Profit Organization Acts as an Agent, Trustee, or Intermediary*. That Interpretation, which is expected to be issued close to the issuance date of this Guide, is expected to provide guidance concerning agency transactions. Accordingly, the Committees believe that sections of the Guide that provide guidance concerning agency transactions beyond the guidance included in FASB Statement No. 116 should be deleted, pending issuance of the FASB's Interpretation. The Committees expect to revise the Guide to incorporate the conclusions included in the Interpretation when it is issued.[2]

**16.** FASB Statement No. 116 provides that unconditional promises to give should be recognized as contribution revenue and receivables in the period in which the promise is received. The Committees considered the application of

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[2] In September 1996, the FASB issued Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power* (an interpretation of FASB Statement No. 116). The provisions of that Interpretation have been incorporated into this Guide.

that guidance to circumstances in which the reporting organization receives the contribution through an agent. The Committees concluded that in circumstances in which the reporting organization receives the contribution through an agent, the reporting organization has in substance received a contribution when the agent has received the contribution, including unconditional promises to give, on behalf of the reporting organization. Therefore, in order to report meaningful information about the financial position, activities, and changes in net assets of the reporting organization, the Committees concluded that if a contribution is transferred to the ultimate recipient through an agent, the ultimate recipient should recognize the contribution when sufficient verifiable evidence that the agent has received the promise to give or other assets becomes available. The Committees considered whether such guidance is operational, because the reporting organization may have no access to information about contributions that the agent has received on its behalf. The Committees believe that in most instances in which agents receive contributions on behalf of the reporting organization, the relationship of the entities will be such that the reporting organization will have access to that information.

## Distinguishing Contributions From Other Kinds of Transactions

**17.** FASB Statement No. 116 includes guidance to help distinguish exchange transactions from contributions. However, that guidance is broad and requires judgment to implement. The exposure draft summarized the guidance in FASB Statement No. 116 concerning distinguishing exchange transactions from contributions and included indicators to help users determine whether certain transactions would be reported as contributions or exchanges. Some respondents commented that the Guide should provide more detailed guidance to help distinguish exchange transactions from contributions. In particular, some respondents noted that, due to the nature of governmental entities' missions, it may be particularly difficult to determine whether resources received from governmental entities should be reported as exchange transactions or contributions. The Committees deliberated this issue and agreed that they were unable to provide guidance beyond that provided by FASB Statement No. 116 and the exposure draft. Accordingly, the Guide includes only the indicators included in the exposure draft.

## Measuring and Reporting Promises to Give

**18.** The exposure draft proposed that unconditional promises to give that are expected to be collected more than one year from the date of the financial statements should be reported at the gross amount of promises to give, less discounts to reflect the present value of estimated future cash flows. The exposure draft also proposed that bad debt expense be reported for the gross amount of promises to give that are expected to be uncollectible and the expense should be reflected in the net asset class in which the contribution revenue is reflected. Also, the exposure draft proposed that any subsequent differences between the estimated and actual uncollectible amounts be reported in the net asset class in which the contribution revenue was originally reflected or in the class in which the net assets are represented.

**19.** Some respondents commented that uncollectible promises to give should not be reported as bad debt expense because such promises are nonreciprocal transactions and the organization incurs no expense if they are not collected. They believe that contributions should be measured at the present value of the amount expected to be collected. Some believe that subsequent-year adjustments due to differences between the amount expected to be collected and the amount actually collected should be reported as adjustments to contributions in the net asset class in which the contribution was originally reported, while others believe that such adjustments should be reported as bad debt expense.

**20.** Others believe that uncollectible promises to give do meet the definition of expenses because such promises are assets and not collecting them is tantamount to an outflow of assets. They note that in some circumstances, management may elect to make no attempt to collect such amounts, and they believe that the effects of such decisions should be reported in the financial statements.

**21.** Some respondents commented that reporting bad debt expense in the net asset class in which the contribution revenue is reported conflicts with the requirement in FASB Statement No. 117 that expenses be reported as decreases in unrestricted net assets. Some respondents suggested reporting the uncollectibility of promises as a loss, rather than as an expense. Some respondents suggested reporting the uncollectibility of promises as a contrarevenue or as a reduction in contributions with financial statement disclosure of amounts netted.

**22.** The Committees agree that uncollectible promises to give should not be reported as expenses on the initial recognition of contributions receivable. The Committees believe such uncollectible promises are a factor to consider in determining the fair value of unconditional promises to give, and therefore are not expenses.

## Split-Interest Agreements

**23.** Some donors enter into trust or other arrangements under which not-for-profit organizations receive benefits that are shared with other beneficiaries. Such agreements are commonly referred to as *split-interest agreements*. The guidance in the Guide concerning such agreements is based on the underlying guidance in FASB Statement No. 116, particularly the requirement that unconditional promises to give should be reported as contributions, measured at fair value. Accordingly, the Committees concluded that unconditional rights to receive assets under such agreements, such as income streams and residual interests in trusts, should be recognized as contributions measured at fair value, which is generally the present value of expected cash flows.

**24.** The assets related to split-interest agreements are invested and administered by either the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. In transactions not involving split-interest agreements, a trustee may hold title to assets in a trust and may have custody of them, but the assets generally are held for the benefit of the beneficiaries, not the trustee. A trustee makes decisions about investing the assets of the trust for the benefit of the holders of the beneficial interests and cannot obtain for itself the benefits represented by those assets. In split-interest agreements, however, a not-for-profit organization acting as trustee has a beneficial interest in the assets of the trust.

**25.** The Committees considered whether a not-for-profit organization should report assets held as trustee under such agreements, and related liabilities, in its statement of financial position. The Committees considered practice for other transactions in which entities hold assets as trustees. For example, paragraph 17.12 of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* provides that "while a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements." The Committees noted that that guidance may not be analogous to a not-for-profit organization acting as a trustee in a split-interest agreement, because such assets may be assets of the not-for-profit organization. The Committees considered whether such assets meet the definition of an asset in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. Paragraph 25 of FASB Concepts Statement No. 6 defines assets as "...probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Paragraph 26 states that—

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the entity's right to or control of the benefit has already occurred.

The Committees concluded that assets held by a not-for-profit organization acting as a trustee in a split-interest agreement meet the definition of an asset because (*a*) the organization has a beneficial interest in assets, (*b*) the organization can obtain the benefit and control other's access to it, and (*c*) the transaction or event giving rise to the organization's right to or control of the benefit (the split interest agreement) has already occurred. Accordingly, the Committees believe that assets held by a not-for-profit organization acting as a trustee under a split-interest agreement should be reported differently than other assets held by other entities acting as a trustee. Further, the Committees believe that reporting only the unconditional right to receive future cash flows from the trust for the organization's interest, and not the assets and liabilities related to those cash flows, would omit relevant information about the organization's performance during the period, such as the economic resources used to produce those future cash flows, and about the organization's management of those resources.

## Contributed Inventory

**26.** The exposure draft proposed that contributions of inventory should be reported in the period received and should be measured at fair value. The exposure draft stated that the item received should not be recognized as a revenue and asset if it has no value, as might be the case for certain clothing and furniture that cannot be sold by the not-for-profit organization. Current practice under SOP 78-10 is to report contributions of inventory at fair value, provided the organization has a clearly measurable and objective basis for determining the fair value. Further, SOP 78-10 provided that, if the materials are such that values cannot be reasonably determined, such as clothing, furniture, and so forth, which vary greatly in value depending on condition and style, they should not be recorded as contributions. Most respondents that commented on this issue believe that contributed inventory should not be reported at fair value. Many respondents said that the costs of reporting that information would exceed the benefits. They believe that such information is impracticable to obtain, unreliable, and not needed by financial statement users.

**27.** The Committees continue to believe that information about the value of contributed inventory is meaningful and that it should be reported. However, the Committees recognize that it may be difficult to obtain. Accordingly, the Guide provides that, if methods such as the use of estimates, averages, or computational approximations can reduce the cost of measuring the fair value of contributed inventory, use of those methods is appropriate, provided the methods are applied consistently and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory.

## Investments

**28.** FASB Statement No. 124 does not address measurement issues concerning investments other than investments in equity securities with readily determinable fair value and all investments in debt securities. Investments not covered by FASB Statement No. 124 are referred to in this Guide as *other investments*. The various AICPA Industry Audit Guides, Audit and Accounting Guides, and Statements of Position that are superseded by this Guide included guidance concerning other investments, but that guidance is inconsistent. The Committees considered whether the Guide should include measurement guidance for other investments, so that all not-for-profit organizations report other investments similarly. The Committees noted that FASB Statement Nos. 115 and 124 provide no guidance for other investments, and that practice for reporting other investments of for-profit entities is diverse. Further, the Committees noted that the Board's primary reason for excluding other investments from the scope of those projects was practical; including other investments in the scope of those projects could have raised significant issues that might not have been resolved in time to complete those projects on a timely basis. The Committees agreed that addressing issues concerning accounting for other investments could have raised significant issues that might not have been resolved in time to complete this Guide on a timely basis. Accordingly, this Guide retains the measurement guidance for accounting for other investments included in the AICPA publications that are superseded by this Guide, until such time as the FASB or AcSEC issues more definitive guidance.

## Reduction in Amounts Charged for Goods or Services

**29.** The exposure draft proposed that, if a not-for-profit organization regularly provides discounts to certain recipients of its goods or services, such as some types of financial aid for students, revenue should be reported net of those discounts. Though the exposure draft was silent concerning whether all financial aid provided by a college and university is a discount, the letter transmitting the exposure draft noted that the Committees believe that not all such aid is a discount and specifically asked respondents to comment on this issue. For example, benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. Most respondents that commented on this issue agreed that the Guide should provide that benefits provided in exchange for services, such as free tuition for employees, are expenses rather than discounts. The Committees agreed that benefits provided in exchange for goods or services provided by a not-for-profit organization are a cost of such goods or services. Accordingly, the Guide provides that reductions in amounts charged for goods or services provided by a not-for-profit organization should be reported as expenses if such reductions are given in exchange for services provided to the organization, such as part of a compensation package.

## Total Fund-Raising and Program Expenses

**30.** FASB Statement No. 117 provides that not-for-profit organizations should report information about expenses reported by their functional classification such as major classes of program services and supporting services. Also, FASB Statement No. 117 provides that the financial statements of not-for-profit organizations should include certain minimum information. However, FASB Statement No. 117 includes no requirements concerning reporting total expenses or particular expense categories. The Committees considered whether the Guide should require not-for-profit organizations to report information other than the minimum information required by FASB Statement No. 117. In particular, the Committees considered whether information about total fund-raising and total program expenses should be reported. The Committees concluded that information about total fund-raising and program expenses is meaningful and useful to users of not-for-profit organization's financial statements. Further, the Committees agree that information about total fund-raising expenses is particularly meaningful to those financial statement users. Accordingly, the Guide provides that the financial statements should disclose total fund-raising expenses and that information about total program expenses should be provided by either disclosing total program expense or by presenting information about the components of total program expenses on the details provided on the face of the statement of activities.

## Illustrative Financial Statements

**31.** The exposure draft did not include illustrative financial statements. FASB Statement No. 117 includes illustrative financial statements; however, those statements illustrate the application of the requirements of FASB Statement No. 117 in a broad manner, rather than illustrating the application of those requirements to specific kinds of organizations, such as colleges and universities, museums, or voluntary health and welfare organizations. The Guide includes illustrations of certain portions of financial statements, as well as certain illustrative disclosures, though it does not include illustrations of industry-specific financial statements. Some respondents commented that the Guide should include industry-specific illustrative financial statements.

**32.** The Committees concluded that the Guide should not be revised at this time to include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117. Though future editions of the Guide may include illustrative financial statements that are more detailed than the illustrative financial statements included in FASB Statement No. 117, the Committees believe that the initial version of the Guide should not include such illustrative financial statements because practice is developing in this area. The Committees believe practice should continue to develop and do not wish to inhibit that development by including illustrations that may, for practical purposes, become practice. The Committees also believe the Guide should be issued as soon as practicable and that including illustrative financial statements would likely delay its issuance. The Committees believe that illustrative financial statements will likely be included in other, nonauthoritative sources, such as continuing professional education courses and manuals issued by industry groups.

## Transition

**33.** The transition rules in this Guide provide that if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.06 through 1.17 of this Guide, entities have the option of either applying the transition rules in the principles being adopted or reporting the cumulative effect of adopting those principles. The Committees considered requiring all changes in accounting principles that result from applying the guidance in paragraphs 1.06 through 1.17 of this Guide to be reported using the transition rules of the pronouncements being adopted. Also, the Committees considered requiring reporting the cumulative effect of all such changes, even in circumstances in which only one principle is adopted. The Committees permitted reporting the cumulative effect in circumstances in which there is more than one change in accounting principle because applying the transition rules in each principle adopted may result in confusing information, the benefits of which would not exceed its costs. However, the Committees concluded that in circumstances in which there is only one change in accounting principle, it would be inconsistent with the principle being adopted to conclude that the cost of applying the transition rules of the principle being adopted exceeds the benefits of applying those transition rules.

## Appendix B

# Statement of Position 92-9

# Audits of Not-for-Profit Organizations Receiving Federal Awards

**With Conforming Changes as of December 18, 1995,** Resulting From the Issuance of *Government Auditing Standards: 1994 Revision* and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*

> SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in December 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. This SOP will be amended to conform to SAS No. 78 nearer to the pronouncement's effective date.

**Prepared by the Not-for-Profit Organizations Committee**
**American Institute of Certified Public Accountants**

## NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Not-for-Profit Organizations Committee regarding the performance of audits in accordance with generally accepted auditing standards, *Government Auditing Standards,* and OMB Circular A-133. (This edition incorporates conforming changes resulting from the issuance of *Government Auditing Standards: 1994 Revision* and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance.*) Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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# SUMMARY

This statement of position (SOP) provides guidance on the auditor's responsibilities when conducting an audit in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. This SOP appends the following AICPA Audit and Accounting Guides:

- *Health Care Organizations*
- *Not-for-Profit Organizations*

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of OMB Circular A-133.
- Summarizes the differences between Circular A-133 and OMB Circular A-128, *Audits of State and Local Governments*.
- Describes the auditor's responsibility for considering the internal control structure and performing tests of compliance with certain laws and regulations.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by Circular A-133.

This SOP incorporates guidance on the following:

- Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- *Government Auditing Standards: 1994 Revision*
- AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*
- The OMB's October 1991 *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*
- The President's Council on Integrity and Efficiency Standards Subcommittee's Position Statement No. 6 [A-133 Questions & Answers]

# Chapter 1

# INTRODUCTION AND OVERVIEW

## Introduction

### *Purpose and Applicability*

**1.1.** The purpose of this statement of position (SOP) is to provide auditors of not-for-profit organizations (NPOs) with a basic understanding of the work they should do and the reports they should issue for audits under—

*a.* The 1994 revision of *Government Auditing Standards* (also referred to as GAS and the Yellow Book), issued by the Comptroller General of the United States.

*b.* Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institution.*[1]

**1.2.** This SOP provides guidance about financial and compliance auditing requirements and requirements to consider the internal control structure promulgated by the American Institute of Certified Public Accountants (AICPA), the General Accounting Office (GAO), and the OMB; and the application of these requirements to NPOs. This SOP, instead of establishing new requirements, consolidates applicable audit requirements established by these organizations in order to facilitate efficient and effective compliance. In addition, this SOP provides guidance for implementing these requirements and includes illustrative audit reports.

**1.3.** This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in audits of every organization. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement so that the audit objectives may be achieved.[2]

**1.4.** The provisions of this SOP are effective for audits in accordance with OMB Circular A-133 for periods ending on or after December 31, 1992.

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[1] Some of the guidance in this statement of position may be helpful for (A) program-specific audits (see paragraph 2.28) and (B) compliance testing in audits of NPOs that are performed in accordance with generally accepted auditing standards (GAAS). Paragraphs 3 through 20 of AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), describe the auditor's responsibility for testing compliance with laws and regulations in an audit conducted in accordance with GAAS. Appendix B of this SOP explains how to obtain these and other relevant publications.

[2] The auditor should refer to relevant AICPA audit and accounting guides, such as *Not-for-Profit Organizations* and *Health Care Organizations.*

## *Relationship of GAAS,* Government Auditing Standards, *and OMB Circular A-133*

1.5. Exhibit 1 presents the relationship among the compliance testing requirements of GAAS, *Government Auditing Standards*, and OMB Circular A-133.[3] (Chapter 2 of this SOP discusses the requirements of Circular A-133.) Statement on Auditing standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), defines the auditor's responsibility to understand and assess audit risk related to compliance, and to design audit procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct and material effect on financial statement amounts in an audit of financial statements under GAAS.

**Exhibit 1**

## Auditing Compliance With Laws and Regulations

**ORGANIZATION-WIDE AUDITS[4] IN ACCORDANCE WITH CIRCULAR A-133**

***Procedures Performed***

*General Requirements:* Testing of compliance with general requirements applicable to federal awards.

*Specific Requirements:*

> *Major programs*: Audit of compliance with specific requirements applicable to major federal programs.
>
> *Nonmajor programs*: Testing of compliance with laws and regulations applicable to nonmajor program transactions selected in connection with the audit of the financial statements or the consideration of the internal control structure over federal awards.

**GOVERNMENT AUDITING STANDARDS**

***Procedures Performed***

Same testing of compliance with laws and regulations as required by GAAS. In addition, under GAS, auditors are responsible for determining compliance with provisions of contracts or grant agreements. GAS also requires reporting on compliance with laws and regulations and provisions of contracts or grant agreements.

**GENERALLY ACCEPTED AUDITING STANDARDS**

***Procedures Performed***

Testing of compliance with laws and regulations in accordance with SAS No. 54, *Illegal Acts by Clients*, and SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, as described in SAS No. 74.

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[3] OMB Circular A-133 is reprinted in appendix A of this SOP.

[4] Audits performed in accordance with Circular A-133 are often referred to as organization-wide audits.

1.6. Exhibit 2 presents the relationship among the requirements to consider the internal control structure under GAAS, *Government Auditing Standards,* and OMB Circular A-133. Guidance on the additional internal control structure testing requirements of OMB Circular A-133 is in chapter 5 of this SOP.

**Exhibit 2**

## Consideration of the Internal Control Structure

**ORGANIZATION-WIDE AUDITS IN ACCORDANCE WITH CIRCULAR A-133**

***Procedures Performed***

Testing of control policies and procedures in the internal control structure over federal awards.

***Reporting***

Requires a report on the internal control structure used in administering federal awards.

**GOVERNMENT AUDITING STANDARDS**

***Procedures Performed***

The same procedures as required by GAAS.

***Reporting***

Requires reporting on the auditor's understanding of the internal control structure over financial reporting and an assessment of control risk under SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* Also requires separate identification of those reportable conditions that are considered to be material weaknesses.

**GENERALLY ACCEPTED AUDITING STANDARDS**

***Procedures Performed***

Obtaining an understanding of the internal control structure over financial reporting sufficient to plan the audit and assess control risk in accordance with SAS No. 55.

***Reporting***

Requires an oral or written report when reportable conditions are noted in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.*

1.7. *Government Auditing Standards* should be followed when required by law, regulation, agreement or contract, or policy. In performing audits in accordance with *Government Auditing Standards*,[5] the auditor assumes certain reporting responsibilities beyond those of audits performed in accordance with GAAS.[6] Thus, *Government Auditing Standards* incorporates fieldwork and reporting standards under GAAS and expands upon certain reporting requirements of GAAS. The additional reporting responsibilities focus on compliance with laws and regulations and provisions of contracts or grant agreements, and the internal control structure over financial reporting. In addition to requirements for reporting on compliance and the internal control structure over financial reporting in all audits, *Government Auditing Standards* includes quality-control, continuing professional education, specific working-paper, and audit follow-up requirements.

## Nature and Purpose of an Organization-Wide Audit

**1.8.** America's hundreds of thousands of NPOs receive billions of dollars of financial assistance every year. The sources of this funding include both governmental and private entities. Much of this funding—even matching support for general program purposes—is given subject to an NPO's compliance with certain laws and regulations. In the past, each sponsor audited its individual program to determine whether the NPO had complied with the applicable laws and regulations. Such compliance audits proliferated, however, and grantees were often tied up for weeks with many sets of auditors. In the late 1970s, the federal government began to develop the single-audit concept. In accordance with this concept, one auditor, most often the independent auditor, would integrate the various sponsors' compliance auditing requirements and their requirements to consider the organization's internal control structure with an audit of the financial statements.

**1.9.** The single-audit concept became United States law for state and local governmental grantees with the enactment of the Single Audit Act of 1984. (For a more detailed history of key events in the history of auditing federal programs, see the audit and accounting guide *Audits of State and Local Governmental Units*.) Circular A-128 is the policy that implements the Single Audit Act. Circular A-133,[7] which was patterned after Circular A-128, was iss-

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[5] *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards for financial audits and not the performance audit standards. However, *Government Auditing Standards* states that the "report 'Contents' and 'Presentation' standards, which are included in the section describing performance audit reporting standards, also apply for financial audits."

[6] Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54.

[7] The audit requirements of Circular A-133 supersede those for certain entities described in attachment F, subparagraph 2h, of Circular A-110, *Uniform Administrative Requirements—Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations*. Institutions subject to Circular A-110 should continue to follow the audit provisions of attachment F to Circular A-110 either until the institutions implement Circular A-133 or (in the case of organizations that are not subject to Circular A-133) as a matter of course. It should be noted that other requirements of A-110 discussed in paragraph 1.27 of this SOP remain in effect for all nonprofit grantees.

ued in 1990. Both Circulars A-128 and A-133 provide guidance on implementing the single-audit concept, although the Single Audit Act itself does not apply to NPOs. Rather, the single-audit concept is described in Circular A-133 as an "organization-wide audit."

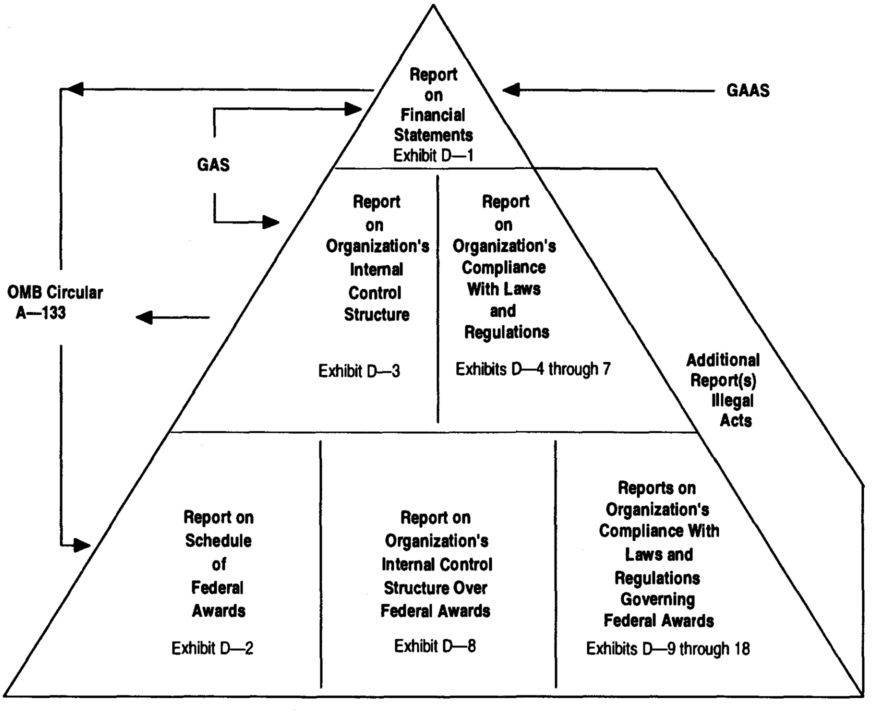
## Components of an Organization-Wide Audit

**1.10.** With certain exceptions, NPOs that receive over $25,000 per year in federal awards are subject to Circular A-133.[8] NPOs receiving less than $25,000 per year in federal awards are exempt from federal audit requirements, but records are to be available for review by appropriate officials of the granting entity or subgranting entity. An organization-wide audit under Circular A-133 has two main components—an audit of the financial statements (paragraph 1.11 of this SOP) and an audit of federal awards (paragraphs 1.12 and 1.13 of this SOP). Each component results in a variety of audit reports. An overview of the various reports issued in an organization-wide audit is presented in exhibit 3.

[8] Organizations receiving awards of $100,000 or more under only one program have the option of having a program-specific audit. Organizations receiving total awards of at least $25,000 but not more than $100,000 per year have the option of having an audit performed in accordance with Circular A-133 or having an audit made of each award. Paragraphs 2.28 through 2.35 of this SOP provide guidance on program-specific audits.

**Exhibit 3**

# Levels of Reporting in Organization-Wide Audits



**1.11.** *Financial Statement Audit.* The financial statement audit required by Circular A-133 is performed in accordance with GAAS and GAS, and results in reports on the financial statements, compliance, and the internal control structure over financial reporting. The primary sources of guidance and standards regarding the auditing of the financial statements of NPOs are the AICPA Statements on Auditing Standards, particularly SAS No. 74; *Government Auditing Standards*; and the AICPA Audit and Accounting Guides *Not-for-Profit Organizations* and *Health Care Organizations.*

**1.12.** *Audit of Federal Awards.* In performing an audit in accordance with Circular A-133, the auditor assumes certain testing and reporting responsibilities beyond those of an audit performed in accordance with GAAS and GAS. Thus, an audit in accordance with Circular A-133 incorporates GAAS and GAS and expands on certain of their testing and reporting requirements. The additional responsibilities focus on compliance with laws and regulations applicable to federal awards and on the internal control structure over federal awards. The terms *single audit, organization-wide audit,* and *entity-wide audit* are frequently used interchangeably by practitioners when they refer to the more extensive form of an audit of federal awards required by Circular A-133.

**1.13.** The audit of federal awards specified in Circular A-133 provides a basis for issuing additional reports on the internal control structure and on compliance. The remainder of this chapter introduces concepts that are important to establishing the scope of an audit of federal awards, summarizes the auditor's responsibilities in such an audit, and previews the other sections of this SOP.

## *Determining the Scope of an Audit of Federal Awards*

**1.14.** Two factors, the relative size of federal award programs and the compliance requirements applicable to these programs, determine the scope of the auditor's work and the reports to be issued in an audit of federal awards under Circular A-133.

**1.15.** *Size—Major versus Nonmajor Programs.* Before an audit begins, the NPO should identify the programs under which it receives federal awards, to prepare the required schedule of federal awards (see chapter 4 of this SOP) and to identify which programs are "major" and which programs are "nonmajor" for audit purposes. For purposes of Circular A-133, a program is an award or group of awards for a similar purpose or general line of inquiry. Federal sponsors have classified awards into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. However, the CFDA may not include all programs. For example, contracts and foreign assistance programs may not be listed in the CFDA. In general, awards that are assigned the same CFDA number constitute a program. The President's Council on Integrity and Efficiency (PCIE) Standards Subcommittee's Position Statement No. 6, Question 24, states that "an exception to the statement that all awards under the same CFDA number constitute a program is when a State government combines different Federal awards into a combined program which is passed through to a not-for-profit recipient. In this case, the State government may require the subrecipient to treat the combined program as a single program for both major program determination and to determine whether a program-specific audit may be elected . . ." In addition, single-program treatment is appropriate under Circular A-133. However, Circular A-133 specifies that awards in two defined categories—student financial assistance and research and development—be classified as separate programs.

**1.16.** PCIE Position Statement No. 6, Question 24, also states that "for awards not assigned a CFDA number, all awards made for the same purpose would be combined as one program similar to how grants under the same CFDA number from multiple funding years are combined as one program." For example, if funds were expended during the audit period from both an original agreement and a separate award that renewed the original agreement, the two awards would be combined and considered as one program.

**1.17.** PCIE Position Statement No. 6, Question 40, states that if the CFDA numbers are not available for awards, the NPO should include the awarding agency name and program name or some other identifier obtained from the award documents in the Schedule of Federal Awards.

**1.18.** The type of reports issued and, therefore, the audit work required in an audit performed in accordance with Circular A-133 depend on whether financial awards received by the NPO constitute major or nonmajor programs. Circular A-133 states that each of the following categories constitutes a major program if total federal expenditures are the larger of 3 percent of total federal funds expended or $100,000:

*a.* Research and development

*b.* Student financial aid

*c.* Individual programs not in the research-and-development or student financial-aid category

**1.19.** Any federal program without sufficient expenditures to be considered a major program is a nonmajor program. As will be discussed, the auditor's responsibilities for major programs generally are greater than those for nonmajor programs.

**1.20.** *Compliance Requirements.* Paragraph 13(c)(1) of Circular A-133 requires that "[t]he auditor shall determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major federal programs." The term Compliance Requirements refers to the laws, regulations, and other requirements that an auditor should consider in making this determination.

**1.21.** The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* (Circular A-133 Compliance Supplement), issued by the OMB and available from the Government Printing Office. For testing general requirements (see paragraph 1.26 of this SOP), the auditor should follow the guidance contained in the Circular A-133 Compliance Supplement. For testing specific requirements (see paragraph 1.24 of this SOP), the auditor should follow the guidance provided for that program, which may be included in either the Circular A-133 Compliance Supplement or the *Compliance Supplement for Single Audits of State and Local Governments.* For programs not listed in the compliance supplements, compliance requirements may be determined by researching the statutes, regulations, grant agreements governing individual programs, or the *Catalog of Federal Domestic Assistance.* Additionally, some agencies have developed audit guides for programs not included in the Compliance Supplement. This guidance, where applicable, may be obtained from the Office of the Inspector General of the appropriate federal agency.

**1.22.** The auditor should be aware that compliance requirements may change over time. Thus, the auditor should also review grant agreements to determine whether specific requirements reflected in the Compliance Supplements have changed. If there have been changes, the auditor should follow the provisions of the Compliance Supplement as modified by the changes.

**1.23.** Paragraphs 13(c)(4) and (5) of Circular A-133 list the compliance requirements on which the auditor should express an opinion. Some of these requirements (e.g., federal financial reports and allowability of expenses) are listed as "general" requirements in the OMB Compliance Supplements; others (e.g., matching and level of effort) are set forth as "specific" requirements of each of the various programs described in the Compliance Supplements.

**1.24.** *Specific Requirements.* These requirements include—

- *Types of services allowed or not allowed,* which specifies the types of goods or services that entities may purchase with financial assistance and the types of costs that may be claimed.
- *Eligibility,* which specifies the characteristics of individuals or groups to whom entities may give financial assistance.
- *Matching, level of effort, or earmarking,* which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided.
- *Reporting,* which specifies reports that entities must file in addition to those required by the general requirements.
- *Special tests and provisions,* which identifies other provisions for which federal agencies have determined that noncompliance could materially affect the program. (For example, some programs specify limits on salaries paid under research grants; other programs prohibit the use of foreign carriers for overseas travel; still other programs set a deadline for the expenditure of federal awards.)

The auditor should note that the following are also considered to be specific requirements:

- Federal financial reports and claims for advances and reimbursements include information that is supported by books and records from which the basic financial statements have been prepared.
- Amounts claimed for reimbursement or used for matching were determined in accordance with the cost principles and matching or cost-sharing requirements set forth in (*a*) OMB Circular A-21, *Cost Principles for Educational Institutions;* (*b*) OMB Circular A-110, *Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations;* (*c*) OMB Circular A-122, *Cost Principles for Nonprofit Organizations;* (*d*) Federal Acquisition Requirements, subpart 31, cost principles; and (*e*) other applicable cost principles or regulations.

These two requirements—federal financial reports and allowable costs—are considered both general and specific by the OMB. Thus, the same audit procedures can be used to test compliance with those requirements.

**1.25.** Although the auditor should test compliance with the requirements specified in the Compliance Supplements, performance of the suggested audit procedures is not mandatory. However, federal Inspectors General recommend their use. The auditor may refer to the statute or Code of Federal Regulations (CFR) identified in the appropriate Compliance Supplement to obtain a complete understanding of the compliance requirements. The auditor may also review award documents and procedure manuals to gain familiarity with the federal compliance requirements. The auditor may also contact the appropriate

Inspectors General office, grantor, or agency to determine the availability of agency-prepared supplements or audit guides for programs not included in the Compliance Supplements.

**1.26.** *General Requirements.* In addition to the specific requirements, the Circular A-133 Compliance Supplement also identifies eight general compliance requirements that apply to all federal award programs. These requirements are:

- Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended)
- Construction contracts (Davis-Bacon Act)
- Civil rights
- Cash management
- Federal financial reports
- Drug-free workplace[9]
- Allowable costs and cost principles
- Administrative requirements (Circular A-110)

**1.27.** Three administrative requirements set forth in Circular A-110—those regarding cash management, financial reporting, and cost principles—are explicitly included among the general requirements. Other administrative requirements included in the Compliance Supplement affect the following matters:

- Interest earned on advances
- Period of availability of funds
- Program income
- Real property
- Equipment
- Supplies
- Subawards to debarred and suspended parties
- Procurement
- Subawards
- Revolving fund repayments

The Circular A-133 Compliance Supplement sets forth audit procedures for testing compliance with three of these requirements: program income, property management, and procurement. The auditor should exercise professional judgment in determining appropriate audit procedures for testing compliance with the other requirements and whether there are other administrative requirements that are relevant in an organization-wide audit of federal awards of an NPO.

**1.28.** The auditor should perform tests of compliance for all of the general requirements applicable to federal awards. Thus, the auditor should test and report on compliance with general requirements regardless of whether or not the NPO being audited has major programs. It has become generally accepted that the nature of the procedures suggested in the Compliance Supplements is sufficient to satisfy the requirements of Circular A-133 with respect to the general requirements. However, the Compliance Supplement does not specify

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[9] Per PCIE Position Statement No. 6, Question 68, the Drug-Free Workplace Act applies to recipients who receive grants directly from federal agencies. The Drug-Free Workplace Act does not apply to subrecipients. However, if a subrecipient is also a prime recipient, the auditor must test for compliance with the Drug-Free Workplace Act. Also, in some cases the prime recipient may by contract pass the Drug-Free Workplace requirements on to a subrecipient.

the extent of such procedures. The auditor should exercise professional judgment in determining the extent of compliance testing of general requirements. Additionally, the auditor should evaluate his or her understanding and assessment of the internal control policies and procedures used in administering programs, and should exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements. Typically, many of these procedures would be performed in conjunction with tests of controls over federal awards.

## The Auditor's Responsibilities in Audits of Federal Awards—An Overview

**1.29.** The extent of the auditor's tests of internal control structure policies and procedures used in administering federal awards and the organization's compliance with laws and regulations is determined by the size of federal award programs and the compliance requirements applicable to them. The following sections briefly describe how program size and compliance requirements determine the scope of each component of the audit of federal awards.

### *The Internal Control Structure Used in Administering Federal Awards*

**1.30.** In audits of federal awards conducted as part of an organization-wide audit in accordance with Circular A-133, the auditor is concerned with the design and operation of the internal control structure policies and procedures relevant to ensuring compliance with both specific and general requirements. The auditor's work in this area is in addition to the consideration of the internal control structure—specifically, obtaining an understanding of the structure and assessing control risk—that is a part of a financial statement audit.

**1.31.** For all major programs, the auditor should document this understanding and assessment, and he or she should test the operating effectiveness of the design and operation of the internal control structure policies and procedures ("test controls") relevant to ensuring compliance with both general and specific requirements. Evidence gained from tests of controls relevant to compliance with specific requirements would likely provide evidence that the auditor could use to determine the nature and extent of testing required to express an opinion on compliance with specific requirements applicable to major programs.

**1.32.** If the total amount of major program expenditures represents less than half of total federal expenditures, or if there are no major program expenditures, the auditor should gain an understanding, assess control risk, and perform a test of controls of the internal control structure for nonmajor programs, until such procedures (including those performed on major programs) encompass programs constituting 50 percent of total federal expenditures. The auditor may select nonmajor programs on a rotating basis so that the control structure over all programs is understood, assessed, and tested over a number of years. The PCIE suggests that these procedures be performed at least once every three years. An alternative to selecting nonmajor programs on a rotating basis (to reach 50 percent of total federal expenditures) is to test controls over the largest nonmajor programs, starting with the largest, until at least half of the total federal expenditures have been subjected to tests of controls.

1.33. With regard to the internal control structure of the remaining nonmajor programs, the auditor should understand the related internal control structure and determine that the controls are in place. The auditor may achieve this understanding and determination on a cyclical basis. In the first year, the auditor should gain an understanding of internal controls and assess risk for all but clearly insignificant nonmajor programs. This process may include inquiries, observations, or walk-throughs. Thereafter, the auditor would obtain an understanding of internal controls and assess control risk for all but clearly insignificant nonmajor programs once every three years. Any new nonmajor programs, other than those that are clearly insignificant, should be reviewed the first year the program is active. If two-year (biennial) audits are performed, all programs should be covered by every second audit.

## Compliance With Laws and Regulations

1.34. The interaction between the relative size of the federal awards program and the type of applicable compliance requirements results in three distinct levels of responsibility for testing and reporting on compliance with laws and regulations in an audit of federal awards. Chapter 6 of this SOP discusses these responsibilities. Chapters 6 and 7 discuss the schedule of findings and questioned costs.

1.35. *Failure to Follow Standards.* The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of Rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons are given.

1.36. *Overview of This SOP.* Chapter 2 of this SOP discusses the requirements of Circular A-133. Chapter 3 discusses planning the organization-wide audit. Chapter 4 describes the Schedule of Federal Awards. Chapter 5 describes the auditor's consideration of the internal control structure in audits performed in accordance with *Government Auditing Standards* and in those performed in accordance with Circular A-133. Chapter 6 discusses compliance auditing requirements. Chapter 7 discusses reporting considerations.

# Chapter 2

# REQUIREMENTS OF OMB CIRCULAR A-133

## Applicability

**2.1.** The applicability of OMB Circular A-133 to an NPO depends on (*a*) the status of its adoption by individual federal and other sponsors, (*b*) the type of NPO, and (*c*) the amount of federal awards it receives.

### *Status of Adoption*

**2.2.** Circular A-133 is directed to federal agencies with an effective date for fiscal years beginning on or after January 1, 1990. Federal agencies may implement Circular A-133 by regulation or contract. The effective date of implementation by the federal grantor agency will determine the effective date for the recipient.

**2.3.** As of the date of this SOP, most major federal agencies have taken steps to implement Circular A-133, either by incorporating it into the Code of Federal Regulations or by issuing internal policy directives and instructions to grantees.

**2.4.** In some cases, states or other recipients have implemented Circular A-133 for their subrecipients under federal awards or for programs funded by their own appropriations.

**2.5.** Question 2 of PCIE Position Statement No. 6 states that if a not-for-profit organization receives federal awards from two federal agencies, one that has implemented Circular A-133 in regulation and one that has not, the "not-for-profit should have an audit in accordance with [Circular] A-133 and include the federal awards from both agencies. An audit done in accordance with Circular A-133 will meet the requirements of A-110."

### *Type of NPO*

**2.6.** Circular A-133 defines a not-for-profit institution as any corporation, trust, association, cooperative, or other organization that—

*a.* Is operated in the public interest primarily for scientific, educational, service, charitable, or similar purposes.

*b.* Is not organized primarily for profit.

*c.* Uses its net proceeds to maintain, improve, or expand its operations.

**2.7.** Accordingly, the NPOs covered by Circular A-133 include colleges and universities (and their affiliated hospitals[10] and community-based organi-

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[10] According to 42 Code of Federal Regulations (CFR) Ch. IV (10-1-91 Edition), Part 409—Hospital Insurance Benefits, Section 409.3 (Definitions), a hospital is a facility that meets the following criteria:
— Is primarily engaged in providing by or under the supervision of doctors of medicine or osteopathy, inpatient services for the diagnosis, treatment, and care or rehabilitation of persons who are sick, injured, or disabled;
— Is *not* primarily engaged in providing skilled nursing care and related services for inpatients who require medical or nursing care;
— Provides 24-hour nursing service; and
— Is licensed or approved as meeting the standards for licensing by the State or local licensing agency as a hospital.

zations such as voluntary health and welfare organizations). Circular A-133 does not apply to—

- Colleges and universities covered by Circular A-128. According to paragraph 6c of OMB Circular A-128, a state or local government can elect to include institutions of higher education in its Circular A-128 audit. State and local government institutions of higher education excluded from the government's Circular A-128 audit can be audited separately under Circular A-128 or Circular A-133.
- Hospitals not affiliated with a college or university.[11]
- State and local governments and Indian tribes covered by Circular A-128.

**2.8.** Except for the public hospitals and universities cited above, Circular A-128 does not apply to NPOs. Before the promulgation of Circular A-133, however, it was not uncommon for state and local government recipients to contractually require Circular A-128 audits of their not-for-profit subrecipients.[12] With the promulgation of Circular A-133, an organization will no longer need an audit in accordance with Circular A-128 and one in accordance with Circular A-133. The subrecipient should clarify the matter with the recipient requiring an A-128 audit. In most cases, the contract can be changed to specify a Circular A-133 audit. Not-for-profit organizations with new contracts should consider making reference to Circular A-133 audit requirements in such contracts.

## *Amount of Federal Awards*

**2.9.** OMB Circular A-133 applies to NPOs that directly or indirectly receive federal awards above a certain threshold, as discussed in paragraph 1.10. The term *federal awards* is defined broadly in Circular A-133 to include federal financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. *Federal financial assistance* is defined as assistance provided by a federal agency to a recipient or subrecipient in the form of grants, contracts, loans, cooperative agreements, loan guarantees, property, interest subsidies, insurance, direct appropriations, and other noncash assistance. For purposes of determining the amount of federal awards, loans and guarantees are afforded a specific treatment.

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[11] Hospitals (e.g., community hospitals) not affiliated with a college or university that are subject to OMB Circular A-110's audit requirement, are subject to statutory audit requirements of Medicaid, Medicare, or other programs in which they participate.

Circular A-133 applies to hospitals "affiliated" with an institution of higher education but not audited as part of a state or local government under Circular A-128. Since Circular A-133 does not define affiliated, the Department of Health and Human Services (HHS) has developed a definition to include hospitals with significant research and training funds. The HHS definition (HHS interim final rule, published *Federal Register*, Friday, March 1, 1991, starting at page 8712) of affiliated includes all situations where—

— Either a hospital or an institution of higher education has an ownership interest in the other entity, or some other party (other than a state or local unit of government) has an ownership interest in each of them

— An affiliation agreement exists

— Federal research or training awards to a hospital or institution of higher education are performed in whole or in part in the facilities of, or involve the staff of, the other entity.

[12] Paragraphs 3.20-3.41 of this SOP discuss the responsibilities of the recipient and subrecipient and their auditors.

2.10. The following guidelines should be used to calculate the value of noncash assistance expended:

| *Types of Noncash Assistance* | *Basis Used to Determine Major Programs* |
|---|---|
| Loans (including guaranteed student loans made by an institution of higher education and loan guarantees) | Value of new loans processed during the fiscal year, plus the balance of loans made in the prior years for which the federal government is at risk, plus any interest subsidy, cash, or administrative cost allowance received |
| Commodities | Value of the commodities issued during the year |
| Insurance | Value of insurance contract |
| Guaranteed student loans that were not made by an institution of higher education | Value of the guaranteed loans made during the year |
| Food stamps | Value of food stamps distributed during the year |

*Note:* Value as used in this table is to be determined by methods or prices prescribed by the federal departments making the award.

2.11. At institutions of higher education and other organizations having student financial assistance (SFA) programs, the value of guaranteed student loans processed during the year, if available, is considered as an expenditure for major program determination. Guaranteed student loans are then combined with other student financial assistance to form the category of SFA. The SFA category total is then compared with the larger of 3 percent of total federal funds expended or $100,000 to determine whether SFA is a major program.

2.12. When determining major programs, the inclusion of noncash programs should not result in the exclusion of other programs from the definition of major programs. PCIE Position Statement No. 6, Question 26, provides guidance for inclusion of loan and loan guarantee programs in the determination of major programs as follows: "When including a loan program significantly affects the number or size of other major programs, the loan program should be considered a major program, and the value attributed to the loan program should be excluded in determining other major programs."

2.13. An organization may receive program assistance in various forms. The classification of cash-supported programs as major or nonmajor depends, as shown in the following table, on whether or not the noncash programs (i.e., loans) are considered to be part of the entity's total federal awards when the 3 percent test is applied:

| Program / Federal Grantor | Federal Awards Received |
|---|---|
| Cash Program A–Labor | $ 1,335,000 |
| Cash Program B–DHHS | 3,000,000 |
| Cash Program C-1–Education | 175,000 |
| Cash Program B-2–Education | 280,000 |
| Cash Program D-HUD (subaward from county) | 310,000 |
| Subtotal Cash Expenditures | 5,100,000 |
| Commodities Program E–U.S. Dept. of Agriculture (subaward from state) | 2,000,000 |
| Subtotal–expenditures–cash and commodities | 7,100,000 |
| Loan Program F–Perkins | 3,500,000* |
| Loan Guarantee Program G–HUD | 7,000,000* |
| Total Federal Awards Expenditures | $17,600,000 |

DHHS = Department of Health and Human Services; HUD = Department of Housing and Urban Development; USDA = United States Department of Agriculture; FFA = Federal Financial Assistance.

* Total of new loans made during the year plus prior-year loans for which the federal government is at risk.

- Major programs are based on the larger of (*a*) 3 percent of $7,100,000 or $213,000 (total cash and noncash federal awards, except for loans and loan guarantees) or (*b*) $100,000. Major programs are those in excess of the higher of these figures, or $213,000.
- Therefore, according to Circular A-133, all programs above, except Program C-1, are major, *including* Programs F and G.
- Programs F and G do *not* count in the total for the test. If Programs F and G were included, major programs would be 3 percent of $17,600,000 or $528,000, making Programs C-1, C-2, and D *nonmajor*.

**2.14.** Once management has prepared the schedule of federal awards and identified each major program, the auditor should assess the reasonableness and completeness of the schedule, as well as management's determination of major programs.

**2.15.** Federal awards shown on the schedule should include pass-through assistance (subawards of federal assistance from nonfederal sponsors) but should not include direct federal cash assistance to individuals.[13]

[13] Medicare funds paid to a not-for-profit provider for health care services to Medicare-eligible individuals are not considered to be federal financial awards subject to Circular A-133 audits.

Medicaid funds paid to a not-for-profit provider of health care services under a fixed-price arrangement generally are not subject to Circular A-133 audits.

However, under certain circumstances, Medicaid funds may be subject to Circular A-133 audits. The following are the most likely circumstances:

- Because state and local funds are also part of the Medicaid program, the state may require the NPO to have an audit in accordance with Circular A-133 (or any other requirements) and/or may require expanded coverage for a number of reasons.
- When Medicaid funds are paid to an NPO to assist the state or local government in administering the Medicaid program, a Circular A-133 organization-wide or program-specific audit would be required. The following are examples:
  - — The state contracts with a not-for-profit peer review organization to administer the Medicaid utilization review function.
  - — The state contracts with an NPO to handle the claims-processing function.

## Receipts

**2.16.** Question 7 of PCIE Position Statement No. 6 states that the definition of a receipt, which determines which entities are subject to Circular A-133, is based on how a recipient recognizes and reports its revenue. It states that "receipt of an award is not tied to when the contract or grant agreement is signed or awarded to the NPO." Generally, a recipient has received awards when it has obtained cash or noncash assistance, or when it has incurred expenditures that will be reimbursed under a federal program. Receipt of federal awards occurs when revenues are recorded in the financial statements.

**2.17.** For programs that involve the receipt of tangible assets (such as food stamps, food commodities, and donated surplus property), "receipts" should be based on the point at which the revenue is recognized according to generally accepted accounting principles. For programs that do not involve the transfer of tangible assets (such as guarantee and insurance programs), "receives" should be based on the transaction or event that gives rise to the award.

**2.18.** Determining the year in which an award is received is particularly important when an NPO is not required to have an audit each year. For example, an NPO may meet the dollar threshold requiring an audit in one year, but not in the next. In this case, the fiscal year audited should match the fiscal year in which the related award activity (expenditures or noncash transactions) occurs.

**2.19.** The following table sets forth the requirements of Circular A-133 for the types of NPOs described in paragraphs 2.6 and 2.7 of this SOP, based on the amount of awards received.

| *What Is the Total Amount of Federal Awards Received in a Year?* | *Is the Organization Required to Follow Circular A-133?* |
|---|---|
| $100,000 or more | Yes. However, if the awards are under only one program, the organization has the option of following Circular A-133 or having an audit of the program based on the requirements governing the program in which the organization participates (see paragraph 2a(2) of the Attachment to A-133). |
| At least $25,000, but less than $100,000 | The organization has the option of than following Circular A-133 or having an audit of each award based on that program's requirements. The requirements for individual program audits are set forth in the respective regulations and audit guides (see appendix B of this SOP). |
| Less than $25,000 | No. However, records must be available for review by appropriate officials. |

**2.20.** PCIE Position Statement No. 6, Question 29, states that noncash assistance such as free rent, interest subsidy, food stamps, food commodities, Women/Infant/Children (WIC) program vouchers, or donated property should be valued at fair market value at the time of receipt to determine the amount of federal award. WIC program vouchers may be valued either at maximum allowed redemption value or average redeemed value.

**2.21.** PCIE Position Statement No. 6 states that receipt of *only* free rent would not be considered a federal award to carry out a program and therefore would not require an audit under Circular A-133. However, the not-for-profit may be subject to monitoring, audit, or other requirements imposed by the federal agency providing free rent.

**2.22.** In some cases, the free rent may be received as part of a federal award or other assistance to "carry out a program." In these cases, the free rent would fall under the definition of "other noncash assistance" and would be included in the total amount awarded for the program, under Circular A-133, paragraph 1e(1).

**2.23.** PCIE Position Statement No. 6, Question 12, states that nonfederal matching is not considered a federal award when determining whether an audit is required. For example, a $25,000 match to a $75,000 federal award would not be considered federal financial assistance; only the $75,000 would be added to any other federal awards to determine whether an audit is required. Once it is determined that an audit is required, however, the auditor should consider whether it is necessary to apply any tests of compliance with requirements applicable to the matching funds.

## Treatment of Loans

**2.24.** PCIE Position Statement No. 6, Question 7, states that "since the federal government is at risk for loans and loan guarantees ('Loans'), until the debt is repaid, the balance of prior year Loans is considered current year financial assistance in each year they are outstanding." PCIE Question 6 notes that if the only federal assistance is prior year Loans, then the NPO may have an audit in accordance with the laws and regulations governing the Loans, according to paragraph 2a(1) of the Attachment to Circular A-133.

**2.25.** Further, PCIE Question 6 states: "however, the Loans may be one time financing with no continuing audit or other compliance requirements except to make repayment. In cases such as this, when the only Federal awards are Loans and the Federal agencies providing the Loans do not require an audit, then Circular A-133 would not require an audit."

## Program-Specific Audits

**2.26.** There are instances where recipients may elect to have a program-specific audit rather than an audit based on the organization-wide requirements of Circular A-133 based on the option described in paragraph 2.19 of this SOP. A program-specific audit is an audit of one federal program in accordance with federal laws, regulations, or audit guides relative to that particular program and does not require a financial statement audit of the not-for-profit entity. By comparison, a Circular A-133 audit is an organization-wide audit that covers all federal awards and requires an audit of the financial statements of the not-for-profit entity. In general, in meeting program-specific requirements, the audit would follow GAS and any specific requirements set forth in the applicable regulations and related audit guides issued by the federal sponsor.

**2.27.** In many cases, a program-specific audit guide will be available to provide guidance on compliance testing, other audit procedures, and reporting. When engaged to conduct a program-specific audit, the auditor should obtain an understanding of the audit requirements for that particular program from the agreement with the grantor agency, from an audit guide published by the grantor agency, or through contact with the grantor agency. The PCIE Standards Subcommittee has prepared a *Program Audit Guide Survey* (October 1991), which is referred to in appendix B of this SOP. Paragraphs 7.50 through 7.53 of this SOP discuss program audit reporting.

**2.28.** PCIE Position Statement No. 6, Question 22, requires that program-specific audits for which no current federal agency guide is available should follow the standards for financial audits in GAS. The reporting should normally include an opinion on the financial statements of the program, a report on the internal controls over the program, and a report on program compliance with laws and regulations. A schedule of findings and questioned costs, a management letter, or a report on illegal acts may also be required when applicable.

**2.29.** PCIE Position Statement No. 6, Question 23, states that—

> When a current program-specific audit guide is not available, the auditor should use the following guidance for general and specific compliance requirements:
>
> > *General Requirements.* The general requirements listed in the *Compliance Supplements* should be included as part of every audit that involves Federal financial assistance. The auditor should review the Circular A-133, *Compliance Supplement* general requirements and consider these in planning the audit. In particular, Federal financial reporting, cash management, allowable costs/cost principles, and administrative requirements will usually apply to all programs.
> >
> > *Specific Requirements.* The specific requirements may be obtained from the compliance supplements, program laws and regulations, or from the sponsoring agency. The auditor may also look to the *Compliance Supplements* or other sources for guidance on suggested audit procedures and the types of compliance requirements to be tested.

## Program-Specific Audits—R&D

**2.30.** The sum of expenditures from awards for research and development (as defined in Circular A-133) received is considered a program, and the sum of expenditures from SFA awards is considered a program. Under a Circular A-133 audit, expenditures for all R&D awards are tested as if they were a single program with possible different compliance requirements within the program. SFA is treated similarly.

**2.31.** A Circular A-133 organization-wide audit is required when there are multiple R&D awards totaling $100,000 or more. A program-specific audit is not acceptable for multiple R&D awards because R&D can be received from many federal agencies and R&D often involves multiple offices or accounting systems within the NPO.

**2.32.** An exception is that a program-specific audit of R&D is permitted when *all* of the following conditions are met:

*a.* There are only R&D awards and all awards are received from a single federal agency, or from a single prime recipient, in the case of a subrecipient.

*b.* The federal agency, or prime recipient in the case of a subrecipient, approves a program audit in advance. The approval should be based upon a determination that the program audit will provide at least the same level of audit coverage over federal funds as the Circular A-133 single audit.

*c.* The program audit is performed in accordance with *Government Auditing Standards* and guidance provided by the federal agency, or by the prime recipient in the case of a subrecipient.

## Program-Specific Audits—SFA

**2.33.** The U.S. Department of Education (ED) and U.S. Department of Health and Human Services (HHS) have agreed to accept an SFA program audit when there are multiple awards but the awards are for SFA. The auditor may consider using the audit guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions*, which may be supplemented as necessary with the program requirements for SFA programs of other federal agencies. For purposes of an audit conducted in accordance with Circular A-133, all SFA programs are considered to be a single major program, while the ED audit guide requires that the auditor consider *each* SFA program to be a major program.

## Associated Organizations

**2.34.** As noted in PCIE Position Statement No. 6, Question 13:

Not-for-profit organizations often create Associated Organizations to perform certain functions for the not-for-profit (e.g., a university athletic foundation, a university association to provide dormitory housing, a not-for-profit creating a separate not-for-profit organization to hold real estate, or a national not-for-profit organization that sponsors local chapters). Common reasons for forming these Associated Organizations are for exemption from restrictions on the NPO to raise funds or to further the purpose of the not-for-profit. In many cases, the same individuals may hold offices in both organizations or the NPO may otherwise exercise control over the Associated Organization.

**2.35.** PCIE Position Statement No. 6, Question 13, also states that the application of the audit requirements under Circular A-133 to such Associated Organizations will depend on the circumstances. The auditor should use the following guidelines:

- When an Associated Organization receives Federal Awards, either as a recipient or subrecipient, it would be subject to Circular A-133 audit requirements.
- When an Associated Organization is included in the NPO's indirect cost allocation plan, the auditor of the NPO may need to test transactions of the Associated Organization in procedures performed relative to indirect costs. The auditor should also consider whether any transactions between the NPO and Associated Organization that affect Federal Awards or otherwise need to be tested as part of the NPOs Circular A-133 audit. If the transactions with the Associated Organization are clearly immaterial, then additional procedures may not be necessary.

- An Associated Organization which meets *all* of the following conditions does not need to be audited under Circular A-133:
  - — It receives no direct or indirect Federal Awards;
  - — It is not included in the NPO's indirect cost allocation plan; *and*
  - — Otherwise it does not receive payments or benefits from the NPO which are paid out of Federal funds.

## Basic Requirements of Circular A-133

**2.36.** Circular A-133 requires an audit of the NPO's basic financial statements, additional audit tests for compliance with applicable laws and regulations, and consideration of the NPO's internal control structure over federal awards.

**2.37.** The audit requirements of Circular A-133 are administered on behalf of the federal government by cognizant agency representatives who are designated or agree to represent the collective interests of the federal government.

**2.38.** Circular A-133 requires the auditor to determine whether—

- The financial statements of an NPO present fairly its financial position and the results of its operations in conformity with generally accepted accounting principles (GAAP).[14]
- The NPO has an internal control structure to (*a*) provide reasonable assurance that it is managing federal awards in compliance with applicable laws and regulations and (*b*) ensure compliance with laws and regulations that could have a material effect on the financial statements.
- The organization has complied with laws and regulations that may have a direct and material effect on its financial statement amounts or on each major federal program.

## Differences Between Circulars A-110 and A-133

**2.39.** Attachment F, subparagraph 2(h), of Circular A-110 includes a broad requirement for an organization-wide financial audit, to be carried out at least biennially. Since the attachment to Circular A-110 included no specific reporting requirements, its application was diverse in practice. Circular A-133 sets forth the audit requirements described in chapter 1 and above.

**2.40.** In 1989, the Standards Subcommittee of the PCIE, which represents the federal Inspectors General, directed in its Statement No. 5 that accountants conducting audits of federal recipients under Circular A-110 should use the audit procedures and reports set forth in a 1989 audit guide promulgated by HHS. In summary, its reporting requirements include the internal control structure and compliance reports of GAS, but do not include the separate internal control structure and compliance reports required by Circular A-133. Circular A-133 supersedes Circular A-110 audit requirements and expands the audit and reporting guidance beyond those contained in the HHS guide. As stated in PCIE Position Statement No. 6, Question 3, "Because an audit conducted in accordance with the HHS Guide would not meet the requirements of Circular A-133, PCIE No. 5 does not apply to Circular A-133 audits. However, PCIE No. 5 remains in effect for Circular A-110 audits performed prior to implementation of Circular A-133."

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[14] Bases of accounting other than GAAP are acceptable. See paragraph 7.4 of this SOP.

## Differences Between Circulars A-128 and A-133

**2.41.** Although Circular A-133 was patterned after Circular A-128, there are differences between the two. The following paragraphs highlight the major differences.

### *Defining Major Programs*

**2.42.** Major programs are defined differently in Circular A-133 than in Circular A-128. For entities that have $100 million or less in expenditures, Circular A-128 defines a major program as any program for which federal expenditures exceed the larger of $300,000 or 3 percent of such total expenditures. For entities that spend more than $100 million, Circular A-128 includes a chart that specifies the amounts used to define major programs. Paragraph 1.18 of this SOP discusses how Circular A-133 defines a major program.

**2.43.** Per Circulars A-128 and A-133, a program can also include several grants, but they should be grouped by their listing in the CFDA; for student financial aid and research-and-development programs, Circular A-133 allows broader groupings whereas Circular A-128 does not.

### *Disclosure of Immaterial Findings*

**2.44.** Circular A-128 requires the auditor to include a description of all findings of noncompliance, including immaterial findings in the audit reports, but Circular A-133 does not. However, under Circular A-133, immaterial findings of noncompliance may be reported either in the report or in a separate written communication to the NPO. This separate communication is referred to in the Circular A-133 compliance reports.

### *Frequency of Audit*

**2.45.** Circular A-128 requires an annual audit, unless the appropriate state or local government established a constitutional or statutory requirement for biennial audits prior to January 1, 1987.[15] Circular A-133 permits audits to be conducted every two years, but only if the recipient does not have an annual financial statement audit, in which case the PCIE has interpreted OMB Circular A-133 to require annual audits as well. If circumstances permit a biennial audit, the entire two-year period must be audited, and the determination for major programs should be based on expenditures for the two-year period. An audit performed in accordance with OMB Circular A-133 should cover the reporting entity's transactions for its fiscal year, which is not necessarily the period of the program being funded.

**2.46.** According to the PCIE Position Statement No. 6, Question 71, the Circular A-133 audit must be annual when the not-for-profit organization has annual financial audits. Since some not-for-profit organizations and their auditors have interpreted Circular A-133 to allow a Circular A-133 audit every two years in all cases, the Inspectors General may use judgment in accepting two-year audits in the first cycle of audits under Circular A-133.

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[15] Circular A-133 Attachment, paragraph 7, states, "Audits shall usually be performed annually but not less frequently than every two years." However, if the statute for the program requires an annual audit, than an annual audit must be performed.

For example, Section 330 of the Public Health Act, which covers community health centers, requires an annual audit. Circular A-133 guidance should be followed in performing an annual audit.

## *Coordinated Audit*

**2.47.** Circular A-128 does not contain a provision for a coordinated audit approach. In recognition of the potential economies gained through mutual reliance among auditors, Circular A-133 permits a coordinated audit approach. A coordinated audit is one in which the independent auditor and federal and other auditors consider each other's work in determining the nature, timing, and extent of auditing procedures.

**2.48.** In most cases, the objectives of GAAS and Circular A-133 can be achieved most effectively by a single auditor, whose work and reports meet the objectives and reporting requirements described in paragraphs 12(b) and 15 of Circular A-133. In other cases, however, internal, state, local, or federal auditors or other federal representatives may be involved as well. In these cases, the auditor should consult with the other auditors to determine whether the other auditors have any work planned, in process, or completed that may be used to satisfy some or all of the other auditor's needs in performing planned work, to avoid duplication of effort. Such work includes work performed by internal auditors, other independent accountants, or specialists such as program reviewers or contracting officers. Circular A-133 states that the coordinated audit approach is not intended to limit the scope of the audit work to preclude the independent auditor from meeting the objectives and reporting requirements described in paragraphs 12(b) and 15 of that circular. For the coordinated audit to succeed, there should be a clear understanding with the recipient, as well as among all auditors involved, as to the specific audit and reporting responsibilities of each.

**2.49.** If the coordinated audit approach is used, the auditor should follow, as appropriate, SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322); SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336); and SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors").[16]

**2.50.** A coordinated audit contemplates that different auditors will provide various reports required by paragraph 15 of Circular A-133. For example, a separate financial statement and compliance audit may be conducted by an auditor, other than the principal auditor, of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements of the parent NPO. Typically, the auditor of the parent will not have performed the procedures necessary to issue the required Circular A-133 reports on compliance and internal control relative to the component unit. When another auditor is involved, the other participating auditors should indicate the division of responsibility in the scope paragraph of their reports on the financial statements, compliance, and the internal control structure, rather than disclaiming an opinion on the work of the other auditor. For professional guidance, the auditor may need to refer to SAS No. 1, section 543. An auditor participating in coordinated audits should carefully evaluate the interrelation-

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[16] In some cases the work of a program reviewer would qualify as that of a "specialist" under AU section 336. If so, the auditor would be required to satisfy himself or herself concerning the reviewer's professional qualifications and understand the purpose and nature of work performed by the specialist. In most cases, a program reviewer cannot satisfy all the work required by and planned under Circular A-133, but it can be a substitute for some of it. The auditor is still required to gain a satisfactory understanding of the internal control structure, assess control risk, and perform some testing of the specific requirements.

ships of the work performed by others and the nature of his or her reliance on them in meeting his or her reporting responsibilities.

**2.51.** In overseeing "coordinated" audits, federal agencies may, in certain cases, request special reports prepared in accordance with SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), or reports on the internal control structure or compliance with certain laws and regulations, in addition to the reports required in accordance with paragraph 15 of Circular A-133. When participating in a coordinated audit, the auditor should understand his or her responsibilities for any additional reporting requirements, and consider documenting this understanding in an engagement letter signed by all parties, before beginning fieldwork.

## Additional Audit Work

**2.52.** Circular A-73, *Audits of Federal Operations and Programs*, provides guidance to federal agencies responsible for processing and assessing the adequacy of audit reports prepared by nonfederal auditors who have been engaged in audits of federal programs. Circular A-73 states in part:

> Federal agencies will rely on recipient audits, provided they are made in accordance with the audit standards issued by the Comptroller General and otherwise meet the requirements of the federal agencies. Federal agencies may perform additional audit work building on the audit work already performed.

**2.53.** The provisions of Circular A-73 do not limit the authority of a federal agency to conduct or contract for additional audits of recipient organizations. However, under Circulars A-73 and A-133, any additional audit work should not duplicate the work already performed. Further, Circular A-133 states that federal agencies contracting for additional audit work are responsible for the additional costs involved.

## Contracting for Audits

**2.54.** Paragraph 10 of Circular A-133 refers to the procurement standards set forth in Circular A-110. These standards provide for cost or price analysis in connection with all of a recipient's purchases, and require that this analysis be documented for procurement over a certain threshold. A responsible procurement is particularly important for audits. Among others, the Mid-America Intergovernmental Audit Forum (see appendix B has produced sample procurement guidelines that may be useful to recipients and their auditors. Circular A-133 provides guidelines for recipients of federal awards to ensure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of Circular A-133.

## Working Papers

**2.55.** *Government Auditing Standards* adds an additional working paper standard for financial statement audits that require working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. Specifically, *Government Auditing Standards* state that working papers should contain—

*a.* The objectives, scope, and methodology, including any sampling criteria used.

*b.* Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.

*c.* Evidence of supervisory reviews of work performed.

**2.56.** Circular A-133 requires auditors to retain working papers and audit reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Working papers are required to be made available on request to the cognizant agency, its designee, or the GAO.

## Other Literature on Organization-Wide Audits

**2.57.** Additional guidance on organization-wide audits has been provided by the Standards Subcommittee of the PCIE and by the AICPA. Appendix B of this SOP lists this guidance and explains how to obtain it. In the planning stage of the audit, auditors should become familiar with the applicable documents presented in appendix B, many of which are discussed in this SOP.

# Chapter 3
# PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF OMB CIRCULAR A-133

## Planning Considerations

**3.1.** In planning an audit in accordance with OMB Circular A-133, the auditor considers several matters in addition to those ordinarily connected with an audit of financial statements in accordance with generally accepted auditing standards and *Government Auditing Standards*. This chapter discusses overall planning considerations in an organization-wide audit in accordance with Circular A-133.

## Overall Organization-Wide Audit—Planning Considerations

**3.2.** Matters that are relevant to planning both components of an organization-wide audit—the financial statement audit and the audit of federal financial assistance—include the following:

- Preliminary assessment of audit risk
- Materiality
- The cognizant agency
- *Government Auditing Standards*, including continuing education and quality-control requirements
- Foreign NPOs
- Subrecipients
- For-profit subrecipients
- Third-party contractors
- Additional responsibilities of the auditor
- Audit follow-up
- State award compliance
- Determination of the audit period
- Initial-year audit considerations
- Joint-audit considerations
- Quality-assessment programs
- The engagement letter
- Other audit services
- The exit conference

### *Preliminary Assessment of Audit Risk*

**3.3.** SAS No. 74 requires that the auditor obtain an understanding of the possible effect of laws and regulations that are generally recognized by auditors to have a direct and material effect on the financial statements (under GAAS and GAS) and on federal financial assistance programs (under OMB Circular A-133). The auditor should consider risk factors related to these laws and regulations and to the related policies and procedures in the internal control structure.

### *Materiality*

**3.4.** Materiality is a significant matter that should be considered in planning the organization-wide audit. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides guidance on the auditor's consideration of materiality when planning and performing an audit of financial statements in accordance with GAAS. (See paragraphs 6.30 through 6.35 of this SOP for a detailed discussion of materiality.)

**3.5.** *Compliance Requirements.* In planning the control structure and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements from the sponsor or the organization at the start of the audit. The entity and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the OMB's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions.* For programs not listed, the auditor may refer to the OMB's *Compliance Supplement for Single Audits of State and Local Governments* or to the regulations and agreements governing individual programs.

## Cognizant Agency

**3.6.** Circular A-133 defines the cognizant agency as a federal agency assigned by the OMB to carry out the responsibilities with regard to an organization-wide audit as defined in paragraph 3 of the Attachment to the Circular. For some organizations subject to OMB Circular A-133, the OMB has assigned a cognizant agency. For other entities, there is an oversight agency with somewhat lesser responsibilities. Paragraph 4 of the Attachment to the Circular describes them.

## Responsibilities of the Cognizant and Oversight Agencies

**3.7.** The OMB has designated cognizant agencies for larger not-for-profit organizations. Smaller NPOs not assigned a cognizant agency are under the general oversight of the federal agency that provides them with the most direct funding. (Where there is no direct funding, the prime recipient providing the most pass-through funding to the NPO will generally assume oversight responsibility.) For assistance in planning, conducting, and reporting on an audit conducted in accordance with Circular A-133, the recipient and auditor may wish to consider this oversight agency in the role played by the cognizant agency, described above.

**3.8.** Paragraph 3 of Circular A-133 states that a cognizant agency has the responsibility to—

*a.* Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of Circular A-133.

*b.* Provide technical advice and liaison to organizations and independent auditors.

*c.* Obtain or make quality-control reviews of selected audits made by nonfederal audit organizations and provide the results, when appropriate, to other interested organizations.

*d.* Promptly inform other affected federal agencies and appropriate federal, state, and local law enforcement officials of any reported illegal acts or irregularities.

*e.* Advise the recipient of audits that have been found not to have met the requirements set forth in Circular A-133. In such instances, the recipients are expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency will notify the recipient and federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance of independent auditors will be referred to appropriate professional bodies for disciplinary action.

*f.* Coordinate, to the extent practicable, audits made for federal agencies that are in addition to the audits made pursuant to Circular A-133, so that the additional audits build upon such audits.

*g.* Oversee the resolution of audit findings that affect the programs of more than one agency.

*h.* Coordinate audit work and reporting among all auditors in order to achieve the most cost-effective audit. Seek the views of other interested agencies before completing a coordinated audit.

**3.9.** Additional information on the responsibility of a cognizant agency is contained in the *Federal Cognizant Agency Audit Organization Guidelines*, issued by the PCIE. It provides guidance for promoting quality audits, processing audit reports, and providing notification of irregularities.

**3.10.** The OMB has stated that the responsibilities of an oversight agency are not as broad as those of a cognizant agency. An oversight agency's primary responsibility is to provide advice and counsel to recipients and their auditors when requested. An oversight agency may take on additional responsibilities if deemed necessary, such as ensuring that audits are conducted and transmitted to appropriate federal officials.

**3.11.** In addition, OMB has designated the Bureau of the Census to act as the overall clearinghouse for Circular A-133 reports.

**3.12.** *Communication With the Cognizant or Oversight Agency.* Although not required by Circular A-133, the auditor may, when professional judgment indicates it is appropriate, communicate with the cognizant agency. If a planning meeting is held with the cognizant agency and the recipient organization, matters such as the following may be discussed:

- The audit plan
- The scope of compliance testing of programs for specific requirements
- The intended use of the Circular A-133 Compliance Supplement
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of federal awards
- Testing the monitoring of subrecipients
- The scope of consideration of internal control structure
- Testing of compliance requirements
- Status of prior-year findings and questioned costs

**3.13.** If the cognizant agency disagrees with significant elements of the audit plan, these matters should be resolved among the recipient, the cognizant or oversight agency (or major funder), and the auditor before fieldwork commences. Communication with and decisions rendered by the cognizant agency should be documented.

## Government Auditing Standards

**3.14.** OMB Circular A-133 requires that the audit be performed by an independent auditor in accordance with *Government Auditing Standards*. The auditor should be aware of AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*. Two of the general standards included in *Government Auditing Standards* relate to continuing professional education and quality control.

**3.15.** *Continuing Professional Education Requirements. Government Auditing Standards* requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, certain auditors performing audits in accordance with GAS should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of these hours should be completed in each year of the two-year period, and at least twenty-four hours should be in topics directly related to the specific or unique environment in which the entity operates. For example, if the auditor performs audits of an entity that is a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the sort of not-for-profit organization being audited.

**3.16.** This requirement applies to auditors responsible for planning, directing, and reporting on audits conducted in accordance with GAS and to those "conducting substantial portions[17] of field work." A detailed interpretation of the CPE standards, *Interpretation of Continuing Education and Training Requirements*, is available from the Government Printing Office (stock number 020-000-00250-6). During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirement.

**3.17.** *Quality Control. Government Auditing Standards* also states that the audit organization should have in place an internal quality-control system and participate in an external quality-review program (for example, peer review). An external quality review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed. Audit organizations should make copies of their most recent external quality-control review report available to the party contracting for the audit.

## Foreign NPOs

**3.18.** Auditors performing Circular A-133 audits of U.S. grantees and their subrecipients (U.S. and/or foreign based) are required to meet *Government Auditing Standards*. No specific exception is provided for foreign auditors. When a subrecipient is a foreign NPO, it may be necessary to use independent auditors who may not fully meet *Government Auditing Standards* such as the continuing education or quality-control standards. In these cases, the auditor should disclose the applicable audit standards that were not met. PCIE Statement No. 6, Question 89, states that the Inspectors General, or recipients in the case of a subrecipient, are expected to use their judgment on whether to accept the reports.

**3.19.** A foreign NPO that is a sub-office of or otherwise included in the financial statements of a U.S.-based NPO, is generally included as part of the audit of the U.S.-based operation and not considered a subrecipient. A foreign NPO that is a subrecipient of a U.S.-based NPO would be subject to Circular A-133.[18] A foreign not-for-profit organization receiving a federal award directly

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[17] Per the GAO *Interpretation of Continuing Education and Training Requirements*, individuals are considered responsible for "conducting substantial portions of the field work" when, in a given CPE year, their time chargeable to audits conducted under GAS amounts to 20 percent or more of their total chargeable time.

[18] General requirements may not apply to a foreign NPO. The auditor should refer to the terms of the award or discuss the matter with the granting agency.

from the U.S. government would be subject to the audit requirements of the terms and conditions of the award. The auditor should be aware that certain federal agencies have issued guidelines for these types of audits. For example, the Agency for International Development (AID) has issued *Guidelines for Audits of AID Assistance Contracted by Foreign Recipients.*

## Subrecipient Versus Vendor Responsibilities

**3.20.** Many NPOs and governmental units make subcontract or subaward awards and disburse their own funds as well as federal funds to subrecipients. In many instances, the amount of these payments or provisions of goods to subrecipients or vendors is material to the primary recipient's financial statements.

**3.21.** The difference between vendors and subrecipients is significant for purposes of the Circular A-133 audit. If an entity that receives pass-through federal funds is classified as a vendor, that vendor's responsibility is to meet the requirements of the procurement contract. If, however, the entity is classified as a subrecipient, then the primary recipient NPO must make certain that the pass-through funds are utilized in accordance with applicable laws and regulations. Examples of a typical recipient-subrecipient relationship include the following:

- A state university receives federal assistance that it disburses to other organizations throughout the state according to a formula or some other basis.
- A regional commission receives federal funds for the feeding of elderly and low-income individuals that are disbursed to not-for-profit organizations to support their feeding programs.
- A state department of social services receives federal funds that are disbursed to NPOs within the state.

**3.22.** The type of entity the subrecipient is determines which circular is applicable. Circular A-128 applies to state or local government subrecipients. Circular A-133 applies to institutions of higher education or other not-for-profit subrecipients.

**3.23.** *Subrecipient.* A subrecipient is defined in OMB Circular A-133 as "any person or government department, agency, establishment, or nonprofit organization that receives financial assistance to carry out a program through a primary recipient or other subrecipient but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a direct recipient of Federal awards under other agreements." According to PCIE Position Statement No. 6, Question 46, "a subrecipient may have some or all of the following characteristics: responsibility for applicable program compliance requirements, performance measured against meeting the objectives of the program, responsibility for program decisions, and determining eligibility for assistance."

**3.24.** *Vendor.* A vendor is an entity generally responsible for providing required goods or services related to the administrative support of the federal award. These goods or services may be for the recipient or subrecipient's own use or for the use of beneficiaries of the program. The vendor's only responsibility is to satisfy the terms of this contract.

**3.25.** Per PCIE Position Statement No. 6, Question 57, "Compliance requirements normally do not pass through to vendors. However, some transactions may be structured such that the vendor should also be responsible for compliance or the vendor's records must be reviewed to determine compliance. In these cases, the NPO is responsible to ensure compliance for applicable transactions by vendors. Methods to ensure this compliance are pre-award audits, monitoring during the contract, and post-award audits. Audits may be done or procured by the NPO or the terms and conditions of the contract may require the vendor to procure the audit."

**3.26.** PCIE Position Statement No. 6, Question 58, states that "when the auditor cannot obtain compliance assurances from reviewing the not-for-profit's records and monitoring procedures, the auditor will need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or relying on work performed by the vendor's independent auditor." PCIE Position Statement No. 6, Question 46, notes that the distinguishing characteristics of a vendor include—

- Providing the goods or services within normal business operations.
- Providing similar goods or services to many different purchasers.
- Operating in a competitive environment.
- Program compliance requirements that do not pertain to the goods or services provided.

**3.27.** The following considerations may help the organization and its auditor decide whether the entity is a subrecipient or a vendor. In some cases, it may be difficult to determine whether the relationship with the NPO is that of a subrecipient or of a vendor. In those cases, the organization and the auditor should make a decision based on the preponderance of answers.

| | | *Yes* | *No* |
|---|---|---|---|
| 1. | Are the funds being disbursed directly or indirectly from a federal source? | Indicative of subrecipient | Cannot be subrecipient |
| 2. | Is the receiving entity a not-for-profit or a governmental entity? | No distinction made | Indicative of vendor |
| 3. | Does the entity that receives the funds have the authority for administrative and programmatic decision-making responsibility and/or eligibility determination? | Indicative of subrecipient | Indicative of vendor |
| 4. | Are the services provided the entity ongoing as opposed to occasional? | Indicative of subrecipient | Indicative of vendor |
| 5. | Do contracts with the entity state that they are to comply with all applicable laws and regulations? Are there performance requirements that must be met and reported? | Indicative of subrecipient | Indicative of vendor |

**3.28.** In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. The federal cognizant, oversight, or sponsoring agency may be of help in making these determinations.

**3.29.** Federal awards normally are redistributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and additional requirements established by the pass-through organization. Hence, the auditor may be required to test compliance, for example, with state as well as federal reporting requirements.

## *Subrecipient Audits*

**3.30.** Under the requirements of Circular A-133, if in a single fiscal year a recipient of a federal award passes through $25,000 or more of that federal award to a subrecipient, the primary recipient is responsible for determining that the subrecipient expends that award in accordance with applicable laws and regulations.[19] Further, Circular A-133 provides that in such instances, the primary recipient should—

- Determine whether not-for-profit subrecipients and, if applicable, governmental subrecipients covered by Circular A-128 have met the audit requirements of Circulars A-133 and A-128, respectively.[20]
- Determine whether the subrecipient spent federal funds provided in accordance with applicable laws and regulations.
- Ensure that appropriate corrective action on reported instances of noncompliance with federal laws and regulations is taken within six months after receipt of the subrecipient audit report.
- Consider whether subrecipient audits necessitate adjustment of the recipient's own records.
- Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with Circular A-133.

**3.31.** Prime recipients are responsible for identifying federal awards to subrecipients. However, when the not-for-profit subrecipient is unable to identify the amount of the award which is federal, the full amount should be considered a federal award of the NPO. The full amount should also be reported on the schedule of federal awards with a footnote that the federal amount cannot be determined.

**3.32.** Although the threshold per Circular A-133 for monitoring subrecipients is $25,000 provided to a subrecipient, Circular A-110 includes certain responsibilities for recipients to monitor subrecipients, regardless of the amount of the subaward.

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[19] Per PCIE Position Statement No. 6, Question 54:

If the prime recipient does not inform the subrecipient that a Federal award is being passed through, and the subrecipient otherwise is not aware that the award is Federal or that an audit is required, then the prime recipient is responsible to make arrangements with the subrecipient for the proper audit. The prime recipient is ultimately responsible for Federal awards passed through to a subrecipient.

The determining factor for A-133 audit requirements is the dollar amount of Federal awards received, not whether the audit is requested. All not-for-profit subrecipients whose total Federal awards received meet the dollar thresholds are required to have an A-133 audit. However, it is essential that the prime recipient identify Federal awards to the subrecipient.

If the prime recipient fails to advise the subrecipient that the award is Federal, this should be considered a weakness in the prime recipient's internal control system for monitoring subrecipients.

[20] In some cases, the award passing through the prime recipient to the subgrantee is the only such award the subrecipient receives. If the subrecipient qualifies for a program-specific audit under such circumstances (see paragraph 2.28), then it would be appropriate for either the prime recipient or the subrecipient to engage an auditor to perform the program-specific audit. When an organization-wide audit is required under Circular A-133, separate program-specific audits of this type will not meet the requirements of the Circular.

**3.33.** Those responsibilities may be discharged by relying on the subrecipients' Circular A-133 audits, relying on appropriate procedures performed by the primary recipient's internal audit or program management personnel, expanding the scope of the independent financial and compliance audit of the primary recipient to encompass testing of subrecipients' charges, or a combination of these procedures.

**3.34.** The primary recipient is also responsible for reviewing audit and other reports submitted by subrecipients, identifying questioned costs and other findings pertaining to the federal awards passed through to the subrecipients, properly accounting for and pursuing resolution of questioned costs, and ensuring that prompt and appropriate corrective action is taken in instances of material noncompliance with laws and regulations.

**3.35.** In establishing its control policies and procedures to monitor subrecipients, the primary recipient should design procedures sufficient to determine a subrecipient's noncompliance with applicable federal rules and regulations that could be material to the subaward. Financial operations of subrecipients related to the federal awards may be subjected to timely and periodic audits. If not, the primary recipient should develop alternative procedures for monitoring their subrecipients. The primary recipient may perform monitoring procedures such as the following:

- Review grant applications submitted by subrecipients to determine that—
  - Applications are approved by subgrantor management before any funds are awarded.
  - Applications are filed in a timely manner.
  - Each application contains the condition that the subrecipient comply with the federal requirements set by the initial federal grantor agency.
- Establish control policies and procedures to provide reasonable assurance that funds are disbursed to subrecipients only on an as-needed basis.
- Disburse funds to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis.
- Bill and collect refunds due from subrecipients in a timely manner.
- Establish control policies and procedures to provide reasonable assurance that subrecipients and those using the funds meet eligibility requirements.
- Review financial and technical reports received from subrecipients on a timely basis and investigate all unusual items.
- Review submitted audit reports to evaluate for completeness and for compliance with applicable laws and regulations to determine whether the appropriate reporting standards were followed.
- Evaluate audit findings, issue appropriate management decisions, if necessary, and determine if an acceptable plan for corrective action has been prepared and implemented. If considered necessary, review the working papers of the auditors.
- Review evidence of previously detected deficiencies and determine that corrective action was taken.

**3.36.** The auditor of the primary recipient should develop an understanding of the design of the recipient's policies and procedures used to monitor subrecipients and determine whether they have been placed in operation. The auditor should also assess the level of control risk by evaluating the effectiveness of the primary recipient's control policies and procedures in preventing or detecting subrecipients' noncompliance with the applicable laws and regulations.

**3.37.** When awards to subrecipients are part of a major program (or a nonmajor program used to meet the 50-percent rule described in paragraph 1.32 of this SOP), the auditor should test the NPO's control policies and procedures used to monitor subrecipients. The tests of controls may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified above as the primary recipient's responsibilities. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the control structure policies and procedures, and professional judgment.

**3.38.** The instances of noncompliance reported in a subrecipient's audit report are not required to be included in the primary recipient's audit report. However, as noted above, the recipient has a responsibility to resolve subrecipients' audit findings directly related to the primary recipient's programs. Thus, the auditor should consider the effects on a major program (or a nonmajor program used to meet the 50-percent rule described in paragraph 1.32 of this SOP) of instances of noncompliance reported in subrecipient audit reports, or reportable conditions, including material weaknesses, in the primary recipient's control policies and procedures used for monitoring the subrecipient.

**3.39.** In many cases, the primary recipient will not have received all subrecipient audit reports in time to incorporate the results into its own audit. Circular A-133 does not require that the reports for prime and subrecipient be issued simultaneously, but that the primary recipient have control policies and procedures to determine that subrecipient audit reports have been received and that corrective action is taken within six months after receipt of the subrecipient's audit report. A subrecipient's audit report may cover a previous period; in choosing whether to use such a report to meet the requirements described previously, the auditor should consider the period covered by the report and its date of issuance. As long as the audit report of the subrecipient is current, it need not cover the same period as the prime recipient's audit. If the subawards are not material to the financial statements and the major programs of the primary recipient, the primary recipient and its auditor should be able to rely on the grantee's subrecipient audit cycle, even if it is not coterminous with the primary recipient's fiscal year.

**3.40.** If subrecipient audits have not been made and the grant awards are material to the financial statements or programs administered by the primary recipient, the scope of the primary recipient's audit can be expanded by management to include testing of the subrecipient records for compliance with the applicable provisions of the general and specific requirements. If the scope of the audit is not expanded, the auditor should consider disclosing the amount of the subaward as a questioned cost and modifying the auditor's report on compliance with laws and regulations. Additionally, the auditor should consider whether deficiencies in the primary recipient's control policies and procedures used to monitor subrecipients may exist.

**3.41.** Per PCIE Position Statement No. 6, Question 53, a prime recipient government's internal auditor who is independent and otherwise meets the qualifications and standards prescribed by Circular A-133 and *Government Auditing Standards* may perform the audit required by Circular A-133 for a subrecipient. However, nongovernmental internal auditors could not perform and report upon subrecipients' audits under Circular A-133 because they are not included in the Circular A-133 definition of independent auditor. A prime recipient's internal auditor, either governmental or nongovernmental, may be used, however, to monitor the subrecipient or assist the independent auditor.

## For-Profit Subrecipients

**3.42.** Circular A-133 does not require audits of for-profit entities. However, an NPO is responsible for ensuring that expenditures from all federal awards are made in accordance with applicable laws and regulations. Methods to ensure compliance for funds passed through to for-profit subrecipients are pre-award audits, monitoring during the contract, and post-award audits.

**3.43.** A prime recipient has the same responsibilities for funds passed through to for-profit subrecipients as it has for not-for-profit subrecipients *except* that Circular A-133 does not establish for-profit subrecipient audit requirements. Since audit requirements are not specified, the contract with the for-profit subrecipient should include applicable administrative, general, and specific compliance requirements.

**3.44.** PCIE Position Statement No. 6, Question 49, states that NPOs should consider establishing appropriate audit requirements and including them in contracts with for-profit subrecipients. Audit requirements a prime recipient may consider including in contracts with a for-profit subrecipient are—

- An audit in accordance with the requirements of Circular A-128 or Circular A-133.
- A program-specific audit.
- Audits and monitoring similar to circumstances involving vendors, as described in paragraphs 3.25 and 3.26 of this SOP.

**3.45.** When a for-profit subrecipient has not had an audit, the prime recipient's auditor is responsible for determining compliance with applicable program requirements. The auditor may meet this responsibility either by reviewing relevant records at the NPO and considering the NPO's control policies and procedures used to monitor the subrecipients, or by performing tests of compliance of the for-profit's records.

## Additional Responsibilities of the Auditor

**3.46.** The auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to those set forth in *Government Auditing Standards* and OMB Circular A-133.

## Audit Follow-Up

**3.47.** The section entitled "Audit Follow-Up" in chapter 4 of *Government Auditing Standards* states:

> Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

**3.48.** The auditor should review the status of action taken on findings reported in prior audits or program reviews, whether they were conducted by independent auditors or by the grantor agency's personnel. When corrective action has not been taken, the deficiency remains unresolved and could be material in the current audit period; the auditor should briefly describe the prior finding and refer to the page on which it appears in the current report. If there were no prior findings and recommendations, a note stating that may be included in the audit report. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to material findings and recommendations can help auditors ensure that the benefits of their work are realized.

## State and Local Award Requirements

**3.49.** In addition to the requirements imposed on recipients by OMB Circular A-133, there may be state award requirements imposed by states that make grants to their political subdivisions and NPOs. In connection with the financial statement audit, the auditor should obtain an understanding of applicable state reporting and compliance requirements that have a direct and material effect on the financial statements being audited. If engaged to audit state grant activity, the auditor should consider performing the following procedures:

- Inquire of management about additional compliance auditing requirements applicable to the entity.
- Inquire of the office of the state or local auditor or other appropriate audit oversight organizations about audit requirements applicable to the entity.
- Review information about governmental audit requirements available from state societies of CPAs or associations of governments.

**3.50.** When the engagement includes auditing compliance with a state or local award, the auditor should consider performing the following steps:

- Read the grant agreements and any amendments.
- Obtain any applicable audit guidance from the state grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- When appropriate, discuss the scope of testing that is expected to be performed with the state grantor agency.

**3.51.** Nonfederal awards received by an NPO from a state or other organization should be distinguished from the federal pass-through funds received. These nonfederal pass-through funds are not considered part of the total federal awards received by an NPO and are not subject to audit in accordance with OMB Circular A-133. The recipient of federal awards that provides pass-through funds to a subrecipient has the responsibility of notifying the subrecipient of (*a*) the amount of federal awards included in the pass-through and (*b*) the federal program name and CFDA number from which such awards were derived.

**3.52.** To become familiar with any additional requirements of state and local grantors, the auditor of a not-for-profit organization should consider performing planning procedures such as the following:

- Inquire about sources of revenue received by the organization and about restrictions, limitations, terms, and conditions under which such revenue is received. Review any agreements directly related to revenue (for example, loans and grants) and inquire about the applicability of any overall regulations of governmental sponsors that apply to the revenue or accounting for the revenue.

- Inquire about compliance and reporting requirements. The audit divisions of sponsoring agencies usually can be helpful in identifying these requirements, which may be identified separately for each recipient or published in an audit guide.

## *Determination of the Audit Period*

**3.53.** An audit performed in accordance with OMB Circular A-133 should cover the reporting entity's financial transactions for its fiscal year (or a two-year period, if there is no annual audit of the financial statements), which is not necessarily the same as the period of the program being funded. Thus, the audit might include only a part of the transactions of a federal award program because some transactions may not occur within the period covered by the audit.

## *Initial-Year Audit Considerations*

**3.54.** An auditor accepting, or contemplating accepting, an engagement in which the federal awards of the preceding period were audited by another auditor is guided by SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). If the awards have not been previously audited, the auditor should discuss with the recipient and the cognizant agency the need to perform any additional audit work for the prior unaudited periods. If additional work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

## *Joint Audits and Reliance on Other Auditors*

**3.55.** In order to comply with Circular A-133's provisions with regard to small and minority firms, certain NPOs may engage small, minority, or socially or economically disadvantaged independent accounting firms on a joint-venture or subcontract basis. In these instances it will be necessary to refer to the work of other auditors.

**3.56.** Prior to entering into an agreement to perform an audit or to subcontract with another firm, the auditor should consider SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), and, for audits of applicable foreign subrecipients, the AID audit guidelines.

**3.57.** At a minimum, the auditor should—

- Ensure his or her own independence of the oversight entity and of each component unit in the reporting entity.
- Confirm the other auditor's independence under Ethics Interpretation 101-10.
- Obtain separate audited financial statements and schedule of federal awards of each component unit.
- Ascertain that an appropriate subsequent-event review was performed for the reporting entity, including all component units and federal programs. This review should include a review of correspondence the entity received after the audit date.

- Obtain representation that the other audit organization and its personnel have met the requirements of *Government Auditing Standards*, including CPE, internal quality control, and external triennial quality-control review.

**3.58.** In some circumstances, each of the auditors participating in the organization-wide audit will have jointly signed an audit report. Signing a report is appropriate only if the auditor is in a position that would justify his or her being the only signatory of the report.

**3.59.** If part of the organization-wide audit is performed by governmental auditors,[21] the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

## Quality Control Reviews

**3.60.** In addition to the quality control requirements set forth in *Government Auditing Standards*, cognizant agencies have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews. As a part of the cognizant agencies' evaluation of completed reports of such engagements and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the inspector general. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency and the independent auditor. SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), discusses certain matters related to the ownership and custody of working papers. SAS No. 41 states that "working papers are the property of the auditor and some states have statutes that designate the auditor as the owner of the working papers." Circular A-133 states that workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency, its designee, or the General Accounting Office at the completion of the audit.

**3.61.** Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the local cognizant agency determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances where the audit was performed by a certified public accountant and the work was determined to be substandard by the Office of Inspectors General, the matter may be submitted to state boards of public accountancy.

## Engagement Letters

**3.62.** It is in the best interest of both the auditor and the organization to document the planning and scope of the audit in an engagement letter. This may minimize confusion and help ensure a proper understanding of the responsibilities of each party. Although not required, the auditor may wish to

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[21] See paragraphs 2.47 through 2.51 of this SOP, which describe the coordinated audit.

discuss the engagement letter with the cognizant agency. Appendix G of this SOP presents an example engagement letter. Auditors should consider describing items such as the following:

- The requirements of *Government Auditing Standards*
- The additional reports required by OMB Circular A-133
- The auditor's and organization's responsibility with respect to reporting illegal acts and noncompliance with provisions of contracts or grant agreements noted during the audit (see paragraphs 5.15 to 5.25 of *Government Auditing Standards*)
- The period covered
- The financial statements and/or programs to be audited
- The reports to be prepared

Auditors should also consider ensuring—

- That representatives of the cognizant agency will have access to the workpapers.
- That these workpapers will be retained for at least three years after the date of the report, or longer if so requested by the cognizant agency.

## Other Audit Services

**3.63.** Footnote 6 to paragraph 1.7 of this SOP notes that if auditors are engaged to perform an audit in accordance with GAAS and discover during the course of the audit that the entity should be obtaining an audit in accordance with *Government Auditing Standards* or Circular A-133, the auditor has an obligation to notify the entity of the requirement for a higher-level engagement (see paragraphs 21, 22, and 23 of SAS No. 74). Circumstances that may indicate higher-level audit requirements include—

- A review of laws, contracts, policies, or grant agreements that contain audit requirements.
- The discovery that the NPO received over $25,000 in federal awards in the year under audit.

## Exit Conference

**3.64.** Upon completion of the fieldwork, the auditor may hold a closing or exit conference with senior officials of the organization. In the case of decentralized operations, as at a university, the federal government encourages preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and administration of sponsored projects.

**3.65.** The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions. This conference also serves to provide the organization with advance information so that it may initiate corrective action without waiting for a final audit report. Whenever possible, the concurrence or the reasons for nonconcurrence by the organization should be obtained and incorporated in the auditor's report. Information on any corrective measures taken or promised to be taken by the organization should also be included in appropriate sections of the report under a caption such as "Organization's Comments."

**3.66.** The auditor may consider documenting the auditors who conducted the exit conference, the names and positions of the organizational representatives with whom exit conferences were held, details of the discussions, and the comments of the organizational officials.

# Chapter 4

# SCHEDULE OF FEDERAL AWARDS

## Types of Awards and Payment Methods

**4.1.** There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA.

**4.2.** Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* Allocations of money to NPOs in accordance with a distribution formula prescribed by law or administrative regulation, for activities of a continuing nature not confined to a specific project. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services.
- *Project grants.* The funding, for fixed or known periods, of specific projects, or the delivery of specific services or products without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* Programs in which the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for repayment of loans.
- *Insurance.* Financial assistance provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.

- *Sale, exchange, or donation of property and goods.* Programs that provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

## Payment Methods

**4.3.** Awards may be paid to NPOs directly or indirectly through reimbursement arrangements in which recipient organizations bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit organizations to draw against letters of credit as grant expenditures are incurred. Certain grants have matching requirements in which participating NPOs must contribute a proportionate share of the total program costs.

## Noncash Awards

**4.4.** Most federal awards are in the form of cash awards. However, some federal programs do not involve cash transactions with NPOs. These programs usually involve commodities received, loan guarantees, loans, or insurance. The value of both cash and noncash awards should be reported as part of the schedule of federal awards or included in a footnote to the schedule. For example, the value of commodities distributed is generally included on the schedule of federal awards either as an expenditure or in a note. The existence and value of federal guarantee, loan, or insurance programs at the end of the fiscal year should be disclosed in a footnote to the schedule. Also, the value of commodities in inventory should be shown in the organization's financial statement or in a footnote to the financial statements. Any interest, subsidy, or administrative cost allowance received during the fiscal year under a loan or loan guarantee program should be included on the schedule.

**4.5.** The individual sources of financial assistance may not be separately identifiable, because of commingled assistance from different levels of government. If commingled assistance is identified, auditors should consider the requirements prescribed by each individual source. For example, a department of state government may receive financial assistance from the federal government and then pass the federal funding through to an NPO, supplemented with its own funds. If this occurs, the subrecipient NPO may be responsible for complying with both federal and state requirements governing that assistance. (See paragraphs 3.30 through 3.41 of this SOP for discussion of subrecipient considerations.) If management or the auditor believes that federal awards may represent combined assistance from various levels of government, management should review contracts or other documents to determine the source of the assistance. If the documentation indicates that awards received from various sources may have been commingled, the subrecipient should make inquiries of the granting agency to determine (*a*) whether the assistance provided includes assistance from other sources, (*b*) the sources and amounts of that additional assistance, if any, and (*c*) the program through which that assistance was provided. PCIE Position Statement No. 6, Question 55, states that if the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule with a footnote describing the commingled nature of the funds. The PCIE suggests that the auditor consider the total amount as federal funds in order to determine the nature and extent of tests.

## *Identification of Major Programs*

**4.6.** Once all sources of federal awards have been identified, federally sponsored programs should be ranked as major and nonmajor according to the amount of expenditures. Noncash assistance should be valued to complete the ranking process, which is described further in paragraphs 2.10 through 2.13 of this SOP.

## *General Presentation Guidance*

**4.7.** Paragraph 15(c)(1) of the Attachment to Circular A-133 requires that the auditor report on a schedule of federal awards.

**4.8.** The information that should be presented on the schedule includes—

- An identification of each major program (except student financial-aid and research-and-development [R&D] programs) as it is identified in the CFDA (normally by program or grant title, and by federal agency and CFDA number).
- An identification of totals for student financial aid and research and development.
- Other federal awards (those federal programs that have not been assigned a catalog number).
- Total expenditures for each federal award program by grantor, department, or agency.
- Total federal awards.

**4.9.** PCIE Position Statement No. 6, Question 29, discusses schedule presentation and includes the following guidance:

- The entity and period covered by the schedule should be the same as those covered by the financial statements.
- The same program (i.e., same CFDA number) from different program years may be combined on one line, although where feasible, presenting program years separately may make the schedule more useful to federal sponsors.
- Major programs should be specifically identified as such.
- Funds passed through from other recipients should be identified as pass-through funds and include the name of the awarding organization, the program identifying number, and the CFDA number.
- The existence and value of federal loans, loan guarantees, or insurance programs at the end of the fiscal year should be disclosed in a note to the schedule.
- Noncash assistance should be shown either in the schedule or in footnotes and valued at fair market value at the time of receipt. Women/Infants/Children program vouchers may be valued either at maximum allowed redemption value or average redeemed value.
- Interest subsidies or administrative cost allowances received under a loan or loan guarantee program should be included in the schedule.
- While not required, it is recommended that where feasible, the NPO provide additional requested information that will make the schedule easier for federal agencies to use. Examples are identification of matching funds, funds passed through to a subrecipient, individual grant numbers or amounts, and grant revenue.

**4.10.** Circular A-133 describes three categories of awards: (*a*) R&D, (*b*) student financial aid (SFA), and (*c*) individual awards not in an R&D or SFA category (Individual Awards—Other). Paragraphs 4.12 through 4.15 of this SOP summarize guidance provided by Question 29 of PCIE Position Statement No. 6.

**4.11.** Although Circular A-133 permits the total of R&D or SFA categories to be listed as one line item on the schedule, more specific identification, such as the following, is generally expected by federal agencies.

## R&D

**4.12.** Where practicable, each individual R&D award should be listed as a separate line in the schedule. However, in some cases, such as a large NPO with many R&D awards, it may not be practical to list each award. In this case, total expenditures may be listed by each federal agency and major subdivision within each federal agency. For example, in the Department of Health and Human Services, a major subdivision would be the National Institutes of Health.

## SFA

**4.13.** Where practicable, each individual SFA program should be listed as a separate line in the schedule by CFDA number. In any case, programs supported by different federal agencies should be listed separately. The existence and value of SFA loans made during the audit period should be shown as a footnote. For institutions of higher education that are not lenders, the footnote amount would be new loans made during the fiscal year. For other not-for-profit organizations, the footnote amount would be the total of new loans made during the fiscal year plus the balance of loans for previous years for which the government is still at risk.

## Individual Awards—Other (Major)

**4.14.** Each Individual Award—Other that is a major program should be listed as a separate line in the schedule by CFDA number.

## Individual Awards—Other (Nonmajor)

**4.15.** Each individual nonmajor award should be listed as a separate line in the schedule by CFDA number under the caption "Other Federal Assistance." Where individual listing is not practicable, the awards should be grouped by awarding agency.

**4.16.** PCIE Position Statement No. 6, Question 36, notes that expenditures may exceed the amount of the award when additional nonfederal sources provide support for a program. The schedule may present nonfederal expenditures but should separately identify federally funded expenditures.

**4.17.** Paragraph 13(c)(2) of Circular A-133 requires NPOs to "identify, in their accounts, all federal funds received and expended and the programs under which they were received." Therefore, when federally funded expenditures cannot be separately identified, the auditor should include a finding in the report on compliance recommending that the NPO separately identify federal funds in subsequent periods.

**4.18.** PCIE Position Statement No. 6, Question 36, states that "when expenditures in excess of current awards represent additional amounts the NPO intends to bill a Federal program, the amount and circumstances concerning the excess should be disclosed in a footnote."

**4.19.** Depending on the circumstances of the engagement and the requirements of federal program managers, the schedule may also include other information for each program, such as the following:

- Matching contributions
- Amount of the program award
- Receipts or revenue recognized
- Beginning and ending balances, such as unexpended amounts or accrued (deferred) amounts

**4.20.** The financial information included in the schedule should be derived from the organization's books and records from which the basic financial statements were prepared. It should be prepared to the greatest extent practical on a basis consistent with other federal grant reports. However, the information included in the schedule may not fully agree with the grant reports because, among other reasons, the grant reports—

- May be prepared on a different fiscal period.
- May include cumulative (from prior years) rather than only current-year data.

**4.21.** Because the information should be presented in the schedule on a basis consistent with other federal grant reports, it may not agree with the basis of accounting used to prepare the NPO's financial statements. Although a reconciliation should be possible, it is not expected that the schedule's data will be directly traceable to the NPO's financial statements, because grant activity is usually not separately identifiable in the fund presentation used in the basic financial statements. The basis of accounting should be discussed in a footnote.

**4.22.** Subrecipients of federal awards should identify program funds that are received directly from the federal government and those that are received as pass-throughs from another NPO or governmental unit. For those funds received from another NPO, the program's identifying number(s) from the CFDA should be included.

**4.23.** PCIE Position Statement No. 6, Question 40, states that "the CFDA number should be available for most domestic Federal financial assistance. Federal agencies and prime recipients are required to provide the CFDA number to recipients and subrecipients when awarding assistance. Not-for-profit organizations are required to identify in their accounts the programs under which funds are received."

**4.24.** International programs and cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the not-for-profit organization should include in the schedule the program name or other identifier obtained from the award documents.

**4.25.** Because federal agencies are the primary users of the supplementary schedule, financial data for state and other nonfederal assistance are not usually presented in it. If such nonfederal data are presented, it should be segregated and clearly designated as nonfederal.

**4.26.** In assessing the completeness of the schedule of federal awards programs, the auditor should consider, among other things, evidence obtained from procedures performed in the audit of financial statements, such as evaluating the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or prime recipients when conducting an audit of a subrecipient.

**4.27.** Appendix E of this SOP provides an illustration of a schedule of federal awards that incorporates the described levels of disclosures.

**4.28.** Other supplemental information may be provided by the NPO if it is considered necessary to meet requirements for full disclosure of grants or other agreements from federal funding sources. The supplemental information may consist of the reconciliation of financial status reports (FSRs) with the schedule of federal awards, or other information that the auditor believes is necessary for full disclosure of federal programs.

# Chapter 5

# CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE

**5.1.** As noted in chapter 1, in an organization-wide audit, the auditor must consider the requirements of generally accepted auditing standards and *Government Auditing Standards*, as well as those of OMB Circular A-133. In most cases, these will be met as part of the single organization-wide effort.

## Consideration of the Internal Control Structure in an Audit Conducted in Accordance With GAAS

**5.2.** SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to obtain an understanding of the internal control structure that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements. In all audits of financial statements, including those of an NPO, this understanding incorporates knowledge about the design of internal control structure policies and procedures relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, and about whether those policies and procedures are in operation.

**5.3.** In planning the audit, such knowledge should be used to—

*a.* Identify types of potential misstatements.

*b.* Consider factors that affect the risk of material misstatements.

*c.* Design substantive tests.

**5.4.** Policies and procedures for all three elements of the internal control structure (control environment, accounting system, and control procedures) may influence the auditor's assessment of control risk for assertions affected by compliance with laws and regulations. For example, the elements of a control environment that may influence the auditor's assessment of control risk include—

- Significant pass-through of funds to subrecipients.
- Requirement to include only allowable and allocable costs in amounts claimed for reimbursement.
- Management's awareness, or lack of awareness, of relevant laws and regulations.
- Organization policy regarding such matters as acceptable operating practices and codes of conduct.
- Assignment of responsibility and delegation of authority for dealing with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- A mixture of volunteers and employees participating in operations. Depending on the size and other features of an organization, day-to-day operations sometimes are conducted by volunteers instead of employees. The manner in which responsibility and authority are delegated varies among organizations, which may affect the control over financial transactions, particularly with respect to authorization.

- A limited number of staff personnel, which sometimes may be too small to provide for appropriate segregation of duties.
- A volunteer governing board, many of whose members serve for limited terms.
- A budget approved by the governing board. The budget may serve as authorization for management to carry out activities in order to achieve an organization's program objectives. Many NPOs prepare budgets for both operating and capital expenditures.

## Procedures to Obtain the Required Understanding

**5.5.** Procedures to obtain an understanding of the organization's internal control structure include the following:

- Obtain background data on the nature of the organization's control environment, including its key staff members. Documents such as the organization's charter, bylaws, and organizational chart may prove helpful.
- Obtain an understanding of the system and control procedures through inquiry, narratives, flowcharts, and other means.
- Obtain a schedule of federal awards and understand what major and nonmajor programs exist and the related general and specific requirements.
- Obtain a copy of the most recent audited financial statements of the organization and review them to determine the nature and volume of sponsored activity (that is, activity for which the organization receives financial assistance) and for indications of problems that relate to sponsored programs.
- Obtain copies of the most recent audit reports on sponsored programs issued by the cognizant agency, other federal or state agencies, or independent auditors. Follow up on the most recent audit findings to determine whether the organization has taken corrective action. This follow-up should include any additional findings or recommendations presented by the cognizant agency in its letter transmitting the report to financial officers.
- Tour the organization and meet its key employees.
- Obtain management identification of applicable laws and regulations and assess it for completeness.
- Obtain an understanding of the internal control structure related to the federal awards.

**5.6.** The auditor should consider whether deficiencies in such internal control structure policies and procedures should be reported in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

## Consideration of the Internal Control Structure in an Audit Conducted in Accordance With *Government Auditing Standards*

**5.7.** Except for certain reporting requirements, *Government Auditing Standards* does not require the auditor to perform any additional work on the internal control structure beyond that required in an audit conducted in accordance with GAAS. Chapter 5 of *Government Auditing Standards* includes requirements beyond those set forth in SAS No. 60 concerning the communication of internal control structure deficiencies, which are described in paragraph 7.8 of this SOP. *Government Auditing Standards* requires auditors to report on their understanding of an entity's internal control structure, and whether the controls have been placed in operation, and on their assessment of control risk. The report, which is based on the results of procedures performed as part of an audit of the financial statements in accordance with GAAS, is described in paragraph 7.7 of this SOP. The report is illustrated in exhibit D-3 of appendix D to this SOP.

## Consideration of the Internal Control Structure in an Audit Conducted in Accordance With Circular A-133

**5.8.** Circular A-133 establishes additional audit procedures and reporting relative to the auditor's consideration of the internal control structure beyond those of a financial-statement audit conducted in accordance with GAAS and *Government Auditing Standards*. These requirements are discussed in the following paragraphs.

### *The Internal Control Structure Used in Administering Federal Awards*

**5.9.** Circular A-133 requires the auditor to obtain an understanding of, assess control risk for, and perform tests of controls on the policies and procedures designed to provide reasonable assurance that an organization is managing federal awards in compliance with applicable laws, regulations, and contract terms and that it safeguards federal funds. The auditor's internal control structure responsibility under Circular A-133 also includes testing a recipient's system for monitoring subrecipients and the controls in effect to ensure that direct and indirect costs are properly computed and billed. These internal controls will be referred to throughout the remainder of this SOP as the "internal control structure over federal awards," to distinguish them from the larger internal control structure of which they are a part.

**5.10.** Circular A-133 defines the internal control structure used in administering federal awards as the policies and procedures established to provide reasonable assurance that—

*a.* The use of resources is consistent with laws, regulations, and award terms.

*b.* Resources are safeguarded against waste, loss, and misuse.

*c.* Reliable data are obtained, maintained, and fairly disclosed in reports.

**5.11.** In addition to these basic control policies and procedures, Circular A-110 and other federal pronouncements (such as program handbooks and guides) specify uniform administrative requirements for grants and agreements with NPOs. Among the administrative requirements are those regarding cash depositories, bonding and insurance, record-retention procedures, program income, cost sharing, matching, financial reporting, monitoring and reporting of program performance, payment requirements, revisions of financial plans, closeout procedures, suspensions and terminations, applications for federal assistance, and standards for property management and procurement.

**5.12.** Although some of these control policies and procedures may have been considered by the auditor in the audit of the financial statements, particularly where federal awards are significant to the financial statements, others go beyond those an auditor may have considered in the audit of the financial statements, as they relate to distribution of salaries, invoice clearance, account reporting, cost transfers, and other matters. In certain cases, deficiencies in administrative procedures (such as those regarding cash receipts, cost sharing, procurement, property management, and financial reporting) may not be significant to the financial statement audit, but may be significant to the operation of federally sponsored programs. Consequently, the OMB has considered these administrative requirements to be a general requirement in the Compliance Supplements.

**5.13.** Although Circular A-133 requires a *report* on the internal control structure, it does not require the auditor to express an *opinion* on the effectiveness of the internal control structure used in administering federal awards. Exhibit D-8 of appendix D of this SOP illustrates the report on program-related controls.

**5.14.** In addition to his or her responsibilities under SAS No. 55, the auditor should perform the following procedures regarding the internal control structure used in administering federal awards:

- Test the effectiveness of the design and operation of the internal control structure policies and procedures for preventing or detecting material noncompliance.
- Review the recipient's system for monitoring subrecipients and obtaining and acting on subrecipients' audit reports.
- Determine whether controls to ensure that direct and indirect costs were computed and billed in accordance with the general requirements are in place.
- Document procedures employed to assess and test the internal control structure.

**5.15.** A literal interpretation of Circular A-133 would require the auditor to perform tests of controls relevant to each federal program regardless of the dollar amount of the program expenditures. However, a somewhat different approach for considering the internal control structure, a description of which follows, has been developed in consultation with representatives of the OMB, the GAO, and the PCIE. The approach was originally developed for audits of state and local governmental units under Circular A-128, but it is considered acceptable under Circular A-133.

## *Major Programs*

**5.16.** For each major program as defined in Circular A-133, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that he or she considers relevant to preventing or detecting material noncompliance with—

*a.* Specific requirements that are applicable to those programs, addressing the types of services allowed or not allowed; eligibility; matching, level of effort, or earmarking; reporting; and special tests and provisions.

*b.* General requirements addressing civil rights, political activity, cash management, the Davis-Bacon Act, federal financial reports, allowable costs and cost principles, the Drug-Free Workplace Act, and certain administrative requirements.

*c.* Requirements governing claims for advances and reimbursements, and amounts claimed for reimbursement or used for matching.

*d.* Cost allocation and subrecipient monitoring, specifically identified in section 13(b)(2) of the Circular A-133 Attachment.

**5.17.** The auditor should consider the results of these tests of controls when evaluating control risk and developing substantive tests to provide a basis for expressing an opinion on compliance with laws and regulations applicable to major programs.

**5.18.** Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55. Tests of controls, which provide evidence of the design and operation of the controls and procedures, may include steps such as (*a*) inquiries of appropriate personnel, including grant and contract managers; (*b*) inspection of documents and reports; (*c*) observation of the application of the specific control policies and procedures; and (*d*) reperformance of the application of the policy or procedure by the auditor. The auditor should perform such procedures regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

**5.19.** Tests of controls may be omitted only in those areas where the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance (in which case, a reportable condition or material weakness should be reported) or in those areas that are not relevant to the compliance determinations discussed in paragraph 5.16.

**5.20.** For purposes of SAS No. 55, a reportable condition is a matter coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee (or its equivalent) because it represents a significant deficiency in the design or operation of the internal control structure that could adversely affect an organization's ability to record, process, summarize, and report financial data in a manner consistent with the assertions of management in the financial statements or to administer federal programs in accordance with applicable laws and regulations.

**5.21.** There may be separate control policies and procedures related to student financial assistance and research and development, which are treated as one program under a Circular A-133 audit. In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the deficiency in relation to the program administered by the control policies and procedures being reviewed as well as the overall program. Some examples are as follows: (*a*) a significant deficiency in specific controls over a single SFA program with significant expenditures, time cards of college work study students, for example, would be considered a reportable condition when considered in relation to the college work study program; (*b*) significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would be a reportable condition when considered in relation to total expenditures of R&D programs; (*c*) a deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition, and the auditor would report a finding in a separate letter.

**5.22.** A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more elements of the internal control structure does not reduce, to a relatively low level, the risk that either errors or irregularities in amounts that would be material to the financial statements being audited, or noncompliance with laws and regulations that would be material to a major federal program,[22] may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

### *Nonmajor Programs*

**5.23.** The auditor may find that the total amount of major program expenditures is less than 50 percent of a recipient organization's total federal cash and noncash award expenditures. In such circumstances, the auditor should select nonmajor programs (to reach 50 percent of federal expenditures) on a rotating basis so that all but clearly insignificant programs are covered at least once every three years. As an alternative, the auditor may perform tests of controls over all the major programs and the largest nonmajor programs until at least 50 percent of federal program expenditures have been subjected to tests of controls performed in accordance with paragraph 1.32 of this SOP.

**5.24.** For all other nonmajor programs, the auditor should, at a minimum, obtain an understanding of each of the three elements of the organization's internal control structure—the control environment, the accounting system, and control procedures—that he or she considers relevant in preventing or detecting material noncompliance with the requirements listed in paragraph 1.26 of this SOP. That understanding should include the design of relevant policies, procedures, and records, and whether the organization has placed them in operation. In obtaining this understanding, the auditor is not required to obtain knowledge about operating effectiveness.

**5.25.** If the recipient organization has no major programs, the scope of the auditor's consideration of the internal control structure used in administering federal award programs should be comparable to the scope applicable to major programs, as described in paragraphs 5.16 through 5.22 of this SOP, for the selected nonmajor programs that, in the aggregate, are equal to or greater than 50 percent of total federal program expenditures. The auditor's consideration of the internal control structure relating to the remainder of the federal programs need not exceed that described in paragraph 5.24 of this SOP.

### *Documentation Requirements*

**5.26.** The auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures related to general and specific compliance requirements. The steps performed and conclusions reached should be clearly evidenced in the auditor's working papers. The working papers should clearly demonstrate the auditor's understanding and assessment of control risk related to the internal control policies and procedures established for federal awards. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraph 5.19 of this SOP, then the rationale for omitting such tests should be documented.

## Cyclical Approach

**5.27.** In some circumstances, such as when multiple operating components of an NPO administer a large number of nonmajor programs, the auditor may obtain the required understanding of internal control structure policies

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[22] For this purpose, a material weakness would include such a condition that related to a major program or a program tested under the 50-percent rule set forth in paragraph 1.32 of this SOP.

and procedures applicable to nonmajor programs on a cyclical basis over a number of years. For a cyclical approach to be acceptable, each nonmajor program for which the cyclical approach is used should be covered at least once every three years. In the first year of the review cycle, the auditor should obtain an understanding of the internal control structure policies and procedures for all programs, except those that are clearly insignificant, about which he or she has not obtained an understanding. Also, the auditor should obtain an understanding of policies and procedures for all new nonmajor programs, except those that are clearly insignificant in the first year that the programs are active. The decision to use the cyclical approach should be discussed with the cognizant agency. If a cyclical approach is used, the auditor's report on the internal control structure should be modified to clearly describe the coverage provided for nonmajor programs.

**5.28.** These steps provide the basis for the report on program-related controls, which is illustrated in exhibit D-8 of appendix D to this SOP.

# Chapter 6

# COMPLIANCE AUDITING

## Compliance Auditing Environment

**6.1.** The auditor should be aware of the unique characteristics of the compliance auditing environment. NPOs differ from commercial enterprises in that they may be subject to the diverse charitable intentions of their donors, who often restrict the use of their funds. Further, federal, state, and local governments have established various laws and regulations that affect NPOs' operations.

**6.2.** Although it is management's responsibility to identify and comply with relevant laws and regulations, the auditor should obtain an understanding of various compliance requirements and adequately train audit personnel. Paragraph 7 of SAS No. 74 discusses how the auditor may obtain an understanding of the effects of laws and regulations. Depending on the environment, auditors should consider including a description of the type of engagement in any proposal, contract, or engagement letter. Such a description would include statements about whether the engagement is intended to meet a cognizant agency's requirements.

**6.3.** A wide spectrum of compliance requirements may apply to NPOs. The requirements vary from state to state and among the several forms of NPOs. Appendix C of this SOP describes various approaches followed by state governments in establishing compliance requirements. The auditor should consider compliance requirements by consulting audit guides or other guidance relevant to the particular engagement.

## The Auditor's Responsibility for Compliance Auditing in Accordance With GAAS

**6.4.** When performing an audit of an NPO in accordance with GAAS, auditors should consider the federal, state, and local laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts.

**6.5.** SAS No. 74 describes the auditor's responsibility for considering laws and regulations and their effect on a GAAS audit. Paragraphs 5 and 6 reiterate the auditor's responsibility for detecting misstatements caused by illegal acts, errors, and irregularities. Paragraph 6 states:

> Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

Paragraph 7 of SAS No. 74 describes the auditor's responsibility to understand the effect of laws and regulations and to consider the related audit risk.

**6.6.** According to SAS No. 74, the independent auditor of an NPO should—

- Assess whether management has identified laws and regulations, noncompliance with which could have a direct and material effect on the determination of amounts in the financial statements.

- Become familiar with those laws and regulations that could have a direct and material effect on financial statement amounts.
- Understand the characteristics of those laws and regulations that could, if they were not followed, potentially lead to a misstatement on the financial statements.
- Assess the risk that a material misstatement has occurred because of such noncompliance.
- Design and conduct an audit to provide reasonable assurance of detecting such material noncompliance.

**6.7.** It is management's responsibility to identify the compliance requirements of the NPO. The auditor should discuss these requirements with the organization's operating personnel, chief financial officer, and, if necessary, legal staff. Those discussions should focus on compliance matters included in laws and regulations, including the bylaws, that could, if not complied with, have a direct and material effect on the financial statements. If necessary, the auditor should contact a state auditor or an appropriate oversight body to obtain information about key areas of compliance applicable to the NPO, including state statutes, regulations, and uniform reporting requirements. In addition, the following approaches may be helpful in identifying compliance requirements:

- Obtain publications pertaining to federal tax and other reporting requirements, such as those of the Department of the Treasury and the Internal Revenue Service pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- Review materials available from other professional organizations, such as state societies of CPAs.
- Identify sources of revenue received by an NPO and inquire about restrictions, limitations, terms, and conditions under which such revenue is received. Review any related agreements (for example, loans and grants) and inquire about the applicability of any overall regulations of governments that apply to the accounting for the revenue.
- Obtain copies of, and review pertinent sections of, the state constitution and state laws concerning the organization. The sections of these documents pertaining to debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- Consider contacting the audit, finance, or program divisions of senior levels of government from which grants are received. They usually can be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

**6.8.** In order to assess the risk of the possible nature of noncompliance with identified laws and regulations and the potential consequences, the auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. Considerations may include: the materiality of the effect on financial statement amounts, the level of management or employee involvement in the compliance assurance process, the opportunity for concealment of noncompliance, and any deficiencies in the internal control structure.

**6.9.** Based on this risk assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance with identified laws and regulations that could have a direct and material effect on the financial statements. In all cases, the auditor should exercise due care and the proper degree of professional skepticism in planning, performing, and evaluating the results of audit procedures to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

**6.10.** Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statements is not, in and of itself, evidence of inadequate planning, performance, or judgment on the part of the auditor.

**6.11.** The auditor should consider obtaining, as part of the written representations from management required by SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), representations from management acknowledging that—

*a.* It is responsible for the entity's compliance with laws and regulations applicable to it.

*b.* It has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

## Illegal Acts—Indirect and Material

**6.12.** Under both GAAS and *Government Auditing Standards*, auditors are required to design and perform the audit to provide reasonable assurance of detecting illegal acts and noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.

**6.13.** Examples of such illegal acts may include violations of occupational safety and health, environmental, food and drug, and price-fixing laws and regulations. Generally, these laws and regulations relate more directly to the nonfinancial operations of an NPO and, accordingly, have only an indirect effect on the financial statements. An auditor ordinarily does not have a sufficient basis for recognizing possible violations of such laws and regulations. Due to the indirect nature of such violations, an audit made in accordance with GAAS provides no assurance that these violations will be detected or that any contingent liabilities that may result will be disclosed. Examples of laws and regulations that fall into this category may include informational tax-reporting requirements and investment policies that, for social reasons, prohibit investments in organizations doing business in certain countries.

## Compliance Auditing Requirements of *Government Auditing Standards*

**6.14.** While incorporating GAAS as described in paragraph 1.5 of this SOP, paragraph 5.15 of *Government Auditing Standards* also requires that the auditor report in written form on compliance with applicable laws and regulations and with provisions of contracts and grant agreements that may have a direct and material effect on financial statement amounts.

## Compliance Auditing Requirements of OMB Circular A-133

**6.15.** In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires that the auditor determine whether "the institution has complied with laws and regulations that may have a direct and material effect on its financial statement amounts and on each major federal program" (paragraph 12[b][3]).

## Major Program Compliance

**6.16.** With regard to major programs, however, Circular A-133 requires that "the auditor obtain sufficient evidence to support an opinion on compliance" (paragraph 13[c][3]). As set forth in Circular A-133, the opinion should cover types of services allowed or not allowed (including, as set forth in the general requirements, compliance with the cost principles), eligibility of program beneficiaries, matching, federal financial reports, and special tests and provisions. The auditor should gain an understanding of the laws and regulations related to these aspects of major programs that is sufficient to assess the risk of material misstatement of program financial results.

**6.17.** In order to determine which federal awards are to be tested for compliance, recipients should identify in their accounts all federal funds received and expended and the programs from which they were received. This includes funds received directly from federal agencies and those passed through from state and local governments or other recipients. The auditor should test the recipient's identification of major programs.

**6.18.** In determining the nature, timing, and extent of testing of an organization's compliance with such requirements, the auditor should consider audit risk and materiality related to each major program. That is, in addition to testing compliance with laws and regulations that have a direct and material effect on the financial statements, the auditor should test compliance with laws and regulations that have a direct and material effect on each major program. This typically results in a lower level of materiality, since materiality is evaluated at the program level rather than at the financial statement level. The testing for compliance provides the basis for the auditor's opinion on compliance illustrated in exhibits D-4 through D-7 of appendix D to this SOP.

**6.19.** Once the NPO identifies major programs, the auditor designs an approach to testing the specific requirements that could have a direct and material effect on the results of each major program. The auditor generally tests the compliance requirements through the following:

*a.* Inquiry, observation, and testing at the organizational level

*b.* Procedures, including tests of transactions, directed at the major program level

**6.20.** The Compliance Supplements set forth compliance requirements regarded by federal agencies as having a potentially direct and material effect on major programs. The Compliance Supplements suggest audit procedures for testing federal programs for compliance with both the general and the specific requirements.

**6.21.** Audits under Circular A-133 include the selection and testing of an adequate number of representative transactions from each major federal program to provide sufficient evidence to support the auditor's opinion on whether the organization has complied, in all material respects, with the specific requirements applicable to each major program. In determining the number of items to select, the auditor should assess materiality in relation to the individual major program being tested rather than in relation to the major programs taken as a whole or in relation to the financial statements.

**6.22.** The extent of testing is based on the auditor's professional judgment regarding factors such as—

- The amount of expenditures for the program.
- The diversity or homogeneity of expenditures for the program.
- The length of time that the program has operated, or changes in its conditions.
- Prior experience with the program, particularly as revealed in audits and other evaluations (for example, inspections, program reviews, or system reviews required by the federal acquisition regulations).
- The extent to which the program is carried out through subrecipients.
- The extent to which the program contracts for goods or services.
- The level to which the program is already subject to program reviews or other forms of independent oversight.
- The results of the tests of adequacy of the controls for ensuring compliance.
- The expectation of adherence or lack of adherence to the applicable laws and regulations.
- The potential impact of adverse findings.

## Nonmajor Program Transactions

**6.23.** The auditor should also consider samples selected during tests of the internal control structure and during the audit of the financial statements to identify nonmajor program transactions that will require further compliance testing.

**6.24.** For the issuance of a report on compliance with the specific requirements applicable to nonmajor program transactions, Circular A-133 requires that transactions selected from nonmajor federal programs be tested for compliance with the federal laws and regulations that apply to such transactions. For example, selection of nonmajor program transactions may occur during an auditor's organization-wide test of payroll or disbursement transactions. If the auditor has selected nonmajor transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions and be reported on in accordance with exhibit D-18 of appendix D to this SOP. If no tests are made of transactions from nonmajor programs, no report is required.

**6.25.** The specific requirements for which nonmajor program compliance should be tested customarily relate to the allowability of the program expenditure and the eligibility of the individuals or groups to whom the NPO provides federal awards. If the auditor selects a transaction from a nonmajor program in the financial statement or internal control work, it is not expected that the general requirements will be tested. For example—

- If, in the audit of the financial statements, the auditor examined a payroll transaction that was directly charged to a nonmajor program, he or she should determine that the position could reasonably be charged to that program and that the individual's salary was correctly charged to that program. (The auditor would not be required to test the transactions for compliance with general requirements, for example, civil rights or cash management requirements.)

- If, during the audit of the organization's disbursements, the auditor examined a travel claim that was directly charged to a nonmajor program, he or she should examine evidence indicating whether the person who performed the travel worked on the program, whether the purpose of the travel was related to the program, whether administrative travel was an allowable charge to the program (for example, whether it complied with the Fly America Act), and whether the travel allowance was within administratively prescribed limits. (The auditor would not be required to test the transactions for compliance with general requirements, for example, civil rights or cash management requirements.)
- If the auditor examined a program-related payment made directly to an individual or organization, he or she should determine whether the payment was for the purpose intended by the program and for services allowed by the program and whether the individual or organization was eligible. (The auditor would not be required to test the transaction for compliance with general requirements, for example, civil rights or cash management requirements.)

## Audit Sampling for Major Federal Programs

**6.26.** As noted above, Circular A-133 requires the auditor to select and test a sufficient number of transactions to support an opinion on compliance with specific requirements related to each major program. Although the term *sampling* is not mentioned, independent accountants often perform audit sampling to achieve this objective. SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol 1, AU sec. 350), discusses the factors to be considered in planning, designing, and evaluating audit samples. In addition, the AICPA Audit and Accounting Guide *Audit Sampling* provides detailed guidance to assist auditors in implementing SAS No. 39. Both documents discuss the use of audit sampling for tests of controls and for substantive tests of details of account balances or classes of transactions.[23]

**6.27.** Although Circular A-133 does not require statistical sampling, it does require that a "representative number of transactions be selected from each major federal financial assistance program." Auditors should use professional judgment in determining sample selection methods and sample sizes for major programs sufficient to support an opinion on compliance with applicable laws and regulations relative to each major program.

**6.28.** The objectives of auditing procedures for federal awards are to provide sufficient, competent evidential matter to provide reasonable assurance of detecting material noncompliance with specific requirements applicable to major federal award programs and issue a report containing either an opinion on compliance with these requirements or a statement that such an opinion cannot be expressed. The testing to obtain those objectives is substantive. Based on the auditor's assessment of control risk, the auditor should select sample sizes that will provide sufficient evidence for a conclusion on the NPO's compliance with the specific requirements applicable to each major program.

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[23] The U.S. Department of Education's *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions* (the Education Audit Guide) specifies testing procedures and sample sizes.

For a Circular A-133 audit, the Education Audit Guide procedures and sample sizes are not required, but the auditor may use them as guidance. However, if the entity elects to have a program audit because it has only one program or it received less than $100,000 in federal awards, the auditor must follow the guidance on testing in the Education Audit Guide.

The auditor's professional judgment should be used when selecting sample sizes. However, when exercising that judgment, the auditor should be aware that samples of a few items with a low dollar value from a large population will probably not be sufficient to enable the auditor to express an opinion concerning compliance.

**6.29.** OMB Circular A-133 requires that an adequate number of transactions be selected from each major program, but it does not require that separate samples be used for each major program. Experience has shown, however, that it is generally preferable to select separate samples from each major program, since the separate sample clearly provides evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate (*a*) that a sample was selected from each major program and (*b*) that the results of tests of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance with the specific requirements.

## Materiality Considerations

**6.30.** In auditing compliance with specific requirements governing major programs in accordance with OMB Circular A-133, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS. In an audit of an NPO's financial statements, materiality is considered in relation to the financial statements being audited. In an audit of an organization's compliance with specific requirements governing major programs in accordance with Circular A-133, however, materiality is considered in relation to *each* major program to which the transaction or finding relates. Although Circular A-133 and the Compliance Supplement require the auditor to test particular specific and general requirements, the auditor should apply the concept of materiality to *each* major program, taken as a whole, rather than to each individual requirement. If the tests of compliance reveal a material misstatement at the program level, the auditor should consider its effect on the financial statements.

**6.31.** For purposes of assessing compliance with laws and regulations governing federal awards in the performance of an organization-wide audit under Circular A-133, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by statutes, regulations, contracts, or grants that results in an aggregation of misstatements (that is, the auditor's best estimate of the total misstatement) that is material to the affected federal award program.

**6.32.** Paragraphs 4.8 and 4.9 of *Government Auditing Standards* state:

> Auditors' consideration of materiality is a matter of professional judgement and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgements are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities and functions.

**6.33.** Qualitative factors indicating an immaterial compliance finding are a low risk of public or political sensitivity, a single exception with a low risk of being pervasive, and the auditor's judgment and experience are that federal agencies or prime recipients would normally not need to resolve the finding or take follow-up action, or that the cost of recovery would exceed the amount of the finding.

**6.34.** Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one period to another. Finally, an error in one period may not be material to a two-year period being audited under the biennial option in Circular A-133.

**6.35.** The auditor should follow a process such as the following in deciding how to report instances of noncompliance for major programs and whether to include them in his or her report on compliance or in a separate communication to management:

*a.* If the noncompliance is not significant (i.e., it does not meet the criteria for materiality discussed in paragraph 6.32 of this SOP in relation to the specific requirements), the auditor may report the finding in a separate communication to management.

*b.* If the noncompliance is significant, the auditor should assess whether it is material to the major program being tested taken as a whole.

*c.* If the noncompliance is material to the major program, the auditor should modify his or her report on compliance.

*d.* If the auditor's assessment is that the noncompliance is material to the specific requirement, but not material to the major program being tested as a whole, the auditor should disclose the matter in his or her report as a finding or questioned cost and not in a separate communication to management.

## *Compliance Testing—Specific Requirements*

**6.36.** The auditor is required to perform sufficient work to render an opinion on whether—

*a.* The amounts reported as expenditures were for allowable services.

*b.* The records show that those who received services or benefits were eligible to receive them.

*c.* Matching requirements, levels-of-effort, and earmarking limitations were met.

*d.* Federal financial reports *and* claims for (1) advances and (2) reimbursements contain information that is supported by the books and records from which the general-purpose or basic financial statements were prepared.

*e.* Amounts (1) claimed for reimbursement or (2) used for matching were determined in accordance with the cost principles and matching or cost-sharing requirements set forth in (*a*) Circular A-21; (*b*) Circular A-110; (*c*) Circular A-122; (*d*) Federal Acquisition Regulation (FAR), subpart 31, cost principles; and (*e*) other applicable cost principles or regulations. It also may be necessary to refer to HHS OASC-3, *Cost Principles for Hospitals*.

*f.* Special tests and provisions where federal agencies have determined noncompliance could materially affect the program. (For example, some agencies set a deadline for the expenditure of federal financial assistance or require that all international travel be performed in accordance with the Fly America Act.) In addition, when auditing a major student financial aid program at an educational institution, an auditor would typically perform compliance testing of the laws and regulations of the Department of Education as specified in the Compliance Supplement relating to the eligibility of participants, the calculation of awards, and exercise of due diligence in the collection of loans.

## *Allowable Costs and Cost Principles*

**6.37.** Transactions selected by the auditor from each major program should be tested to determine whether the costs meet the criteria of the cost principles that apply to each program. The auditor's working papers should document the applicable criteria reviewed, the results of the audit work performed, and the conclusion reached by the auditor.

**6.38.** The cost principles set forth in Circulars A-21 and A-122, FAR subpart 31, and HHS OASC-3 establish standards for determining costs applicable to grants, contracts, and other agreements. Costs are allowable for federal reimbursement only to the extent of benefits received by the federal programs. To be eligible for federal reimbursement, both direct and indirect costs should meet the criteria generally contained in the Basic Considerations section of the applicable cost principles. These criteria require that the cost be—

- Necessary and reasonable for the performance and administration of the federal program and allocable thereto under the provisions of the cost principles.
- Authorized or not prohibited under state or local laws or regulations and approved by the awarding agency, if appropriate. Certain costs require specific approval by the grantor agency, while some are not allowed as set forth in the section of the applicable cost principles dealing with Selected Items of Costs.
- In conformance with any limitations or exclusions set forth in the applicable cost principles, or with any limitations in the program agreement or specific requirements in the program regulations.
- Given consistent treatment with policies, regulations, and procedures applied uniformly to federal and nonfederal activities of the recipient organization.
- Given consistent accounting treatment within and between accounting periods and not allocable to, or included as a direct cost of, a federal program if the same or similar costs are allocated to the federal program as an indirect cost.
- Determined in accordance with generally accepted accounting principles or another comprehensive basis of accounting.

- Not included as a cost or used to meet cost-sharing requirements of another federally supported activity of the current or a prior period.
- Allocable to the federal awards. The charges should be allocable to a particular cost objective (such as a grant, project, or other activity) in accordance with the relative benefits received. A cost is allocable to a federal award if it (*a*) is incurred specifically to advance the work under the award; (*b*) benefits both an award and other work and can be distributed in an equitable manner in relation to benefits received; (*c*) is necessary to the overall operation of the organization; and (*d*) is otherwise allowable under the cost principles provided in HHS OASC-3, if applicable, and OMB Circulars A-21 and A-122. An allocable cost of an award or other cost objective may not be shifted to other federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of an award.
- Net of all applicable credits, for example, volume or cash discounts, refunds, rental income, trade-ins, scrap sales, direct billings (in the case of indirect cost), etc.
- Supported by underlying documentation (for example, time and attendance payroll records, personnel activity reports or other time and effort records for employees charged to federal awards or to more than one activity, approved purchase orders, receiving reports, vendor invoices, canceled checks, etc.), as appropriate, and correctly charged as to account, amount, and period.

**6.39.** There should be an advance understanding for special or unusual costs. The reasonableness and allocability of certain items of costs may be difficult to determine. Should such costs be disclosed during the audit, the auditor should determine whether the organization had an advance understanding about whether the costs would be considered allowable. The understanding should preferably be in writing and approved by the awarding or cognizant agency in advance of the expenditure; otherwise the costs may be disallowed.

**6.40.** If subject to prior approval in accordance with HHS OASC-3, OMB Circulars A-21 or A-122, or the terms of the award, the charges should be approved in advance. OMB Circulars A-21 and A-122 and HHS OASC-3 indicate that prior approval is required for specific types of expenditures, such as for the purchase of equipment and for foreign travel. In addition, an award agreement may require advance approval for other specific costs.

## *Indirect Costs*

**6.41.** In addition to federal reimbursement for direct program costs, NPOs often receive reimbursement for indirect costs or for the costs of centralized services. To obtain reimbursement, NPOs generally should establish a basis for allocating such costs to federal programs by preparing a cost allocation plan or an indirect-cost rate proposal. Cost allocation plans and/or indirect-cost rate proposals can differ significantly between large and smaller not-for-profit organizations. For example, one of the most basic differences is that most large organizations have multiple missions, while the missions of smaller NPOs are more narrowly focused. These multiple missions of large organizations may benefit from indirect costs in a variety of ways. These costs are usually allocated on a multiple allocation-base method—a method in which the use of cost pools may obscure the details of what costs are actually included in the cost pools.

**6.42.** *Smaller Entities.* Small NPOs usually have missions that benefit equally from indirect costs. For these NPOs, the allocation of indirect costs may be accomplished by separating the entity's total costs as either direct or indirect costs and dividing the total allowable indirect cost by an equitable distribution base to arrive at an indirect-cost rate. By reviewing a schedule of the costs included in the direct and indirect areas it is usually possible to identify the major unallowable or inappropriate costs. To assess the allowability of such indirect costs, the auditor should refer to procedures set forth for indirect costs in the general requirements section of the Compliance Supplements. Auditors should note that although an opinion specifically related to the allocation of indirect costs is not required, allowability of total costs is one of the specific requirements on which the auditor opines.

**6.43.** *Compliance Requirement (Indirect Costs Only).* The NPOs indirect-cost rate proposal provides the basis for allocating indirect costs to federal programs and for negotiating an indirect-cost rate. Circulars A-88 and A-122 provide for cognizance systems whereby one federal agency is designated as the cognizant agency to deal with a college, university, or nonprofit organization on behalf of the entire federal government and to negotiate indirect-cost and other rates, which are used by all other federal agencies in dealing with that recipient organization. In most cases, therefore, proposals are submitted to an appropriate cognizant agency.

**6.44.** Proposals are usually prepared on a prospective basis using actual financial data from a prior period or budgeted data for the current year. When the actual costs for the year are determined, the differences between the originally proposed costs and the actual costs for the year are either carried forward to a subsequent period's rate or adjusted with the granting federal agency on a retroactive basis. In cases where predetermined rates are determined and approved by the cognizant federal agency, subsequent adjustments are not made, with the exception of eliminating any unallowable costs. Audit procedures must be tailored according to the type of rate and size and type of organization being audited. If unallowable costs are found, cost recoveries and adjustments should be made in accordance with the provisions of the applicable cost principles.

**6.45.** *Universities.* Indirect costs are apportioned between research and the other major functions of a university (such as instruction, other sponsored activities, and other institutional activities), based on various allocation procedures prescribed in Circular A-21. That portion of indirect costs identified with research is then further distributed to individual research projects by an indirect-cost rate(s). Where necessary, an indirect-cost rate is also established for the instruction function and for Other Sponsored Programs.

**6.46.** Indirect costs at large educational institutions are normally classified in the following categories: (*a*) building and equipment depreciation/use allowances, (*b*) operation and maintenance expenses (including utility expenses), (*c*) general administration expenses, (*d*) departmental administration expenses, (*e*) sponsored projects administration expenses, (*f*) library expenses, and (*g*) student administrative services expenses.

**6.47.** Currently, most large universities use a predetermined indirect-cost rate. This rate is negotiated in advance for future years (normally a three-year period) based upon a proposal that uses costs from a prior year. An example would be a university that has a negotiated predetermined indirect-cost rate with no provision for carryover for the three fiscal years 1989, 1990, and 1991.

Usually, the indirect-cost proposal would be prepared in fiscal year 1991 using fiscal year 1990 costs and would be the basis for the indirect-cost rates in fiscal years 1992, 1993, and 1994. The audit of the 1990 fiscal year would include testing the indirect-cost proposal that was prepared using 1990 data. The next indirect-cost proposal required to be submitted by the institution would use fiscal year 1993 costs and be submitted within six months of the end of fiscal year 1993. In this example, there is no requirement that an indirect-cost proposal be submitted for fiscal years 1991, 1992, and 1994.

**6.48.** An auditor engaged to audit fiscal year 1991, 1992, or 1994 would not be required to audit the indirect-cost proposal, as none was required to be submitted. However, the auditor for the years when a proposal was not required to be submitted would be required to test the financial systems that will be used in preparing future indirect-cost proposals. Examples of such systems are those for equipment and fixed assets and those used in classifying expenditures. An auditor would also be concerned that costs treated as indirect in the negotiating process were not being charged as direct costs. This would require an understanding of the previous proposal. If the auditor finds any unallowable costs that were included in a proposal (whether in the current proposal or in a previous proposal on which the 1991, 1992, or 1994 rate was based), these costs should be questioned.

**6.49.** If a predetermined indirect-cost rate with no provisions for carry-over has been negotiated for the year under audit, the opinion on whether costs claimed are allowable would be related to the application of the negotiated rate. The indirect-cost proposal that is the basis for claiming costs in future years would be tested as a general requirement. In cases where the negotiated rate is provisional or has a carry-forward provision, the indirect-cost proposal would affect the specific requirement related to the allowability of costs.

**6.50.** *Procedures for Indirect Costs.* The Circular A-133 Compliance Supplement sets forth the following procedures for audits of indirect costs. These procedures may be modified for smaller entities.

*a.* Determine whether indirect costs are charged to federal awards. If not, the rest of this section does not apply. If such costs are charged, the following guidelines should be followed.

*b.* Obtain and read the current negotiation agreement, as well as any agreements, conditions, or understandings related thereto, and determine the types of rates and procedures required.

*c.* Select a sample of claims for reimbursement submitted to the federal agency and determine whether the amounts charged and rates used are in accordance with agreements, and whether rates are being properly applied to the appropriate base.

*d.* Determine whether the rates used or amounts charged are final or predetermined, or whether they are still open to adjustment or revision, either immediately or as a carry-forward adjustment in a future period. If final, the results of the audit work should be reflected, if appropriate, in recommendations for future procedural improvements. However, if the final or predetermined rates include unallowable costs, they should be identified and reported along with the estimated federal share of the costs.

*e.* Determine whether costs or types of costs, chargeable directly to federal awards or any other direct activity (including any costs required for matching or cost changing), have been eliminated from the pool of indirect costs and included in the allocation or rate base.

*f.* Determine whether the established procedures to identify and eliminate unallowable costs are comprehensive and applied in a consistent manner. Verify that the results of these procedures are incorporated into the indirect-cost proposal submitted to the cognizant agency.

*g.* Test supporting documentation to determine whether—

- The indirect-cost pools contain only items that are consistent with the applicable cost principles and negotiated agreements. This testing should be aimed at determining whether the indirect-cost pools contain any unallowable costs, as defined by the cost principles (e.g., entertainment, lobbying, etc.).
- The methods of allocating the costs are in accordance with the provisions of the appropriate cost principles, other applicable regulations, and negotiated agreements and produce an equitable distribution of costs.
- Statistical data (e.g., square footage, population or full-time equivalents, salaries and wages) in the proposed allocation bases are current, reasonable, updated as necessary, and do not contain any material omissions.
- Personnel activity reports, time and effort reports, or other methods used to allocate salary and wage costs are mathematically and statistically accurate, are implemented as approved, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged.
- Special costs analysis studies (such as library studies or energy studies) are mathematically and statistically accurate, are factually based to the extent possible, use reasonable and supportable assumptions, produce reasonable results, and, if appropriate, agree with any prior agreements with, or conditions placed by, the cognizant agency concerning such studies.
- The data can be reconciled with the most recently issued financial statements. Investigate significant reconciling items.

## Other Testing Considerations

**6.51.** As noted above, the Compliance Supplement contains suggested audit procedures that, if completed by the auditor, constitute a safe harbor, that is, such procedures are deemed to meet OMB and grantor agency audit expectations. PCIE Position Statement No. 6, Question 63, states that "for programs contained in a Compliance Supplement which have not had subsequent changes, an audit of the requirements contained in the Compliance Supplement will meet the A-133 single audit requirements." Although each requirement appearing in the Compliance Supplement is accompanied by suggested audit procedures that can be used to test for compliance with laws and regulations, the auditor is not restricted to the use of only these audit procedures. The auditor should use professional judgment in determining the appropriate audit procedures.

**6.52.** An auditor may also be engaged to test and report on compliance with state and local laws and regulations. Although Circular A-133 does not specifically address auditing compliance requirements for state or local government grants, state or local assistance may be covered by a state's audit requirement. Such a requirement may specify compliance tests, similar to those set forth in Circular A-133, to be performed at the option of the local government or in accordance with state law. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of required testing. However, state or local government funds provided to NPOs should be distinguished from state or local pass-throughs of federal funds. The latter pass-through funds are considered part of the federal awards received by the local recipient when conducting an audit in accordance with Circular A-133.

## Compliance Testing—General Requirements

**6.53.** The Compliance Supplements identify general requirements for which the auditor should test compliance in all Circular A-133 audits. The auditor should test for compliance with general requirements whether or not the NPO has major programs. The auditor is not expected to express an opinion on an NPO's compliance with the general requirements. However, two general requirements (i.e., allowable costs and federal financial reports) are also included in the opinion on specific requirements as noted in Circular A-133. Rather, as illustrated in exhibit D-15 of appendix D to this SOP, the report provides positive and negative assurance and sets forth procedures and material findings. The general requirements are described in the following paragraphs.

**6.54.** *Political Activity.* The Hatch Act and the Intergovernmental Personnel Act of 1970, as amended, specify that federal funds cannot be used for political activity of any kind.

**6.55.** *Davis-Bacon Act.* When required by applicable legislation, construction programs are required to follow the provisions of the Davis-Bacon Act, which in general requires wages of laborers and mechanics employed by contractors of federally funded projects to be no lower than the prevailing regional wage rate as established by the Secretary of Labor.

**6.56.** *Civil Rights.* Federal programs provide that no person shall be excluded from participation or be subjected to discrimination in any program funded, in whole or in part, by federal funds because of race, color, national origin, sex, age, or physical impairment.

**6.57.** *Cash Management.* Many recipients receive funds through a letter-of-credit arrangement with the grantor agency. Cash should be withdrawn only in amounts necessary to meet immediate needs or to cover program disbursements already made.

**6.58.** *Federal Financial Reports.* Attachment H of Circular A-110 specifies that recipients of federal awards should file the financial reports for each federal award program. Paragraphs 6.62 through 6.65 below discuss the review of federal financial reports.

**6.59.** *Allowable Costs and Cost Principles.* These principles prescribe the direct and indirect costs allowable for federal reimbursement.

**6.60.** *Drug-Free Workplace.* This law prescribes that organizations certify that they provide a drug-free workplace (see paragraph 6.66).

**6.61.** *Administrative Requirements.* These prescribe administrative requirements that should be followed (see paragraph 6.67).

### *Review of Federal Financial Reports*

**6.62.** In connection with tests of compliance with applicable laws and regulations, Circular A-133 states that the auditor should determine whether the "federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared...." The Compliance Supplements require the auditor to determine if the federal financial reports are presented in accordance with Attachment H, "Financial Reporting Requirements," of Circular A-110.

**6.63.** The auditor should compare the statement of expenditures incurred under federally sponsored programs, as shown on the Schedule of Federal Awards, with the books and records of the organization and, as a part of his or her testing of control policies and procedures used in administering federal awards, compare the books and records with periodic financial reports to the federal government for tested items. This requirement has generally been interpreted to mean that federal financial reports are traceable to the recipient's financial records, that is, they are not based on estimates.

**6.64.** Attachment H describes the following reports that recipients should prepare, if applicable, and submit to the federal government:

- A financial status report
- A federal cash-transactions report
- A request for advance or reimbursement
- An outlay report and a request for reimbursement for construction programs

**6.65.** Individual federal award agreements may include the specific reporting requirements to be followed by the recipient. However, Attachment H establishes the standard financial-reporting requirements for all federal awards programs. When auditing a subaward or a state award or program, the auditor would also test financial reports submitted to the prime recipient or state.

## *Drug-Free Workplace*

**6.66.** Direct recipients of grants and cooperative agreements from any federal agency are required to certify that they will provide a drug-free workplace as a precondition for receiving the grants. All grantees, except states, are required to make this certification for all grants. States, including state agencies, may elect to make an annual certification to each federal agency from which they obtain financial assistance. This requirement also applies to contractors that have contracts of $25,000 or more with the federal government. PCIE Position Statement No. 6, Question 68, states that the requirement does not, however, extend to subrecipients, unless the subgrantor (primary recipient) requires compliance with Drug-Free Workplace Act requirements. The federal government does not make this requirement.

## *Administrative Requirements (OMB Circular A-110)*

**6.67.** Circular A-110 includes various administrative requirements with which NPOs should comply.[24] The requirements of Circular A-110 apply to federal awards in the form of grants and cooperative agreements. Federal awards

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[24] The OMB Compliance Supplement for Institutions of Higher Education and Other Non-Profit Institutions contains specific procedures for—

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|---|---|
| • Financial reporting. | • Program income. |
| • Cost principles. | • Procurement. |
| • Cash management. | • Property management. |

in the form of entitlements generally are granted to states and passed through to NPOs. Such awards would be subject to the terms of the subaward as well as Circular A-110. Contracts are covered by their own terms and conditions.[25]

## Other General Requirement Testing Considerations

**6.68.** The Compliance Supplements suggest procedures that can be performed to test an organization's compliance with the general requirements; however, the application of the Compliance Supplements' procedures is only recommended, not required. It has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of Circular A-133 with respect to the general requirements.

**6.69.** The auditor should issue a report on compliance with general requirements regardless of whether the NPO being audited has major programs. Determining the extent of any tests of compliance with general requirements is a matter of professional judgment. Among the matters the auditor considers are the extent of any tests of compliance with general requirements performed for major programs. If the NPO being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with general requirements provide evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional procedures to test compliance with the general requirements would need to be performed.

**6.70.** Many organizations receive federal awards from several federal agencies and, consequently, develop uniform controls and procedures over all federal programs. In relation to general requirements, however, many organizations may not formally document their administrative controls and procedures, since they are considered to be requirements that are unrelated to the determination of financial statement amounts. To identify the established controls and procedures for these general requirements, the auditor normally makes inquiries of key personnel of the organization, including grant managers. The auditor may also identify these controls and procedures by reviewing policy and procedure manuals, if any exist, and by observing the general workplace of the organization. The auditor's report on the general requirements is described in paragraph 7.24 and illustrated in exhibit D-15 of appendix D to this SOP.

### *Evaluation of Noncompliance*

**6.71.** The auditor's tests of compliance with laws and regulations may disclose instances of noncompliance or questioned costs. Under Circular A-133, material instances of noncompliance and questioned costs should be reported in a schedule of findings and questioned costs and reported as discussed in paragraphs 7.29 through 7.31 of this SOP. The auditor may describe immaterial findings in a separate letter to the organization or include them with the report covering material instances of noncompliance. Paragraph 15 of the Attachment to Circular A-133 requires management to submit a copy of the letter covering immaterial instances of noncompliance to the federal grantor agencies or subgrantor sources. Although the auditor may issue as many as

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[25] PCIE Position Statement No. 6, Question 67, states that, "since program income will normally be included in Federal financial reports, the auditor should consider program income in determining whether Federal financial reports contain information that is supported by books and records from which the basic financial statements are prepared. The auditor's responsibility for program income, as it relates to internal controls and compliance testing, is the same as that for program expenditures."

four different compliance reports in an organization-wide audit, findings and questioned costs may be presented in one schedule.

**6.72.** When instances of noncompliance with general requirements are identified and can be quantified, materiality is generally assessed at the program (or programs) level to which the noncompliance relates, and a determination to modify the auditor's report should be made at that level. However, when the noncompliance is not quantifiable (for example, failure to adopt a drug-free workplace policy), materiality is generally assessed at the financial statement level; that is, the auditor should consider the effect of any contingent liability in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

**6.73.** The level at which materiality is assessed is critical in assessing whether a modification to the unqualified auditor's report is needed. In determining whether such a modification is needed, the auditor should—

*a.* Assess the actual error noted against the materiality level established for the individual program.

*b.* Assess the projected error against the materiality level established for the individual program.

**6.74.** If the auditor determines that the actual error is material to the individual program, depending on the circumstances, the auditor's report should be modified as illustrated in appendix D of this SOP. If the projected error is material to the individual program, the auditor should consider whether additional audit procedures should be applied.

**6.75.** Auditors also have the responsibility of assessing the impact of the actual and projected error noted in the testing on the financial awards programs against the materiality level established for the basic financial statements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.31), states:

> If the auditor concludes, based on his or her accumulation of sufficient evidential matter, that the aggregation of likely misstatements causes the financial statements to be materially misstated, he should request management to eliminate the material misstatement. If the material misstatement is not eliminated, he should issue a qualified or adverse opinion on the financial statements.

**6.76.** Guidance on qualified audit reports is provided in chapter 7 of this SOP. Circular A-133 does not require that the auditor's report on compliance include a projection of questioned costs to the universe of federal programs, nor does it require that the auditor expand the scope of an audit to determine with greater precision the effect of any questioned costs. However, there may be instances in which the circumstances of specific questioned costs could establish a basis for the auditor, the grantor, or both to question all costs charged to a federal program or programs. For example, if eligibility requirements or matching or cost-sharing conditions have not been met by the recipient, the entire amount expended in connection with affected programs may be questioned. If such questioned costs are subsequently disallowed by the federal agency, the entire amount may be required to be refunded by the recipient. The auditor should consider the effect of the liability or contingent liability on the basic financial statements. FASB Statement No. 5 provides guidance on accruing and disclosing contingent liabilities.

**6.77.** The auditor is required by Circular A-133 to identify the total amounts of questioned costs, if any, for each federal award as a result of noncompliance, and to recommend any necessary corrective action. The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal grantor agency will ultimately disallow a questioned cost, because the grantor has considerable discretion in these matters. The nature of the questioned costs, as well as the amounts involved, are considered by the grantor in deciding whether to disallow them. Most federal grantor agencies have established appeal and adjudication procedures for questioned costs.

**6.78.** The auditor should evaluate the effect of reportable conditions and noncompliance on all of the reports required by Circular A-133.

## Reporting Illegal Acts

**6.79.** Circular A-133 requires the auditor to report any illegal acts as set forth in *Government Auditing Standards.*

**6.80.** *Government Auditing Standards* requires that any illegal acts or indications of illegal acts be reported. Pages 53 through 56 of *Government Auditing Standards,* particularly paragraphs 5.18 through 5.25, discuss the appropriate parties who should be informed of illegal acts. (Paragraphs 7.15 and 7.16 of this SOP discuss illegal acts.)

## Findings and Questioned Costs

**6.81.** Chapter 5 of *Government Auditing Standards,* in footnote 5 to paragraph 5.19, states the following:

> Audit findings have often been regarded as containing the elements of criteria, condition, and effect, plus cause when problems are found. However, the elements needed for a finding depend entirely on the objectives of the audit. Reportable conditions and noncompliance found by the auditor may not always have all of these elements fully developed, given the scope and objectives of the specific financial audit. However, auditors should identify at least the condition, criteria, and possible asserted effect to provide sufficient information to federal, state, and local officials to permit them to determine the effect and cause in order to take prompt and proper corrective action.

**6.82.** When performing an audit in accordance with GAAS, the auditor should consider the effect of any instance of noncompliance on the financial statement opinion. When auditing in accordance with *Government Auditing Standards,* the auditor is required to report on the results of the auditor's testing of compliance with laws and regulations at the general-purpose financial statement level. Also, the auditor is required by Circular A-133 to issue reports on compliance with requirements applicable to federal awards. Chapter 7 of this SOP describes these reporting requirements. Appendix D of this SOP includes illustrative compliance reports.

### *Criteria for Questioning Costs*

**6.83.** The criteria established for questioning costs that are to be reported in the compliance report vary from one agency to another. Many of the criteria are imposed by Congress at the time the programs are authorized and funds are provided; other criteria are established through agency regulations. Generally, the criteria for reporting questioned costs relate to the following:

- *Unallowable costs.* Certain costs specifically unallowable under the general and special award conditions or agency instructions, including, but not limited to, pre-grant and postgrant costs and costs in excess of the approved grant budget, either by category or in total.

- *Undocumented costs.* Costs charged to the grant for which adequate detailed documentation does not exist (for example, documentation demonstrating their relationship to the grant or the amounts involved).
- *Unapproved costs.* Costs that are not provided for in the approved grant budget, or for which the grant or contract provisions or applicable cost principles require the awarding agency's approval but for which the auditor finds no evidence of approval.
- *Unreasonable costs.* Costs incurred that may not reflect actions that a prudent person would take in the circumstances, or costs resulting from in-kind contributions to which unreasonably high valuations have been assigned.

The auditor should review prior audit reports and other related correspondence to determine the nature of previous findings and questioned costs, as well as the status of unresolved issues. (See paragraphs 7.29 through 7.31 for further discussion of findings and questioned costs.)

## Client Representations—Audits Performed Under OMB Circular A-133

**6.84.** The auditor should obtain certain written representations from management as part of an audit conducted to express an opinion on compliance with requirements that have a material effect on a federal award program. Representations that should ordinarily be obtained in an organization-wide audit include the following:[26]

*a.* Management has identified in the schedule of federal awards all awards provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.

*b.* Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal awards.

*c.* Management has identified the requirements governing the types of services allowed or not allowed: eligibility; matching, level of effort, or earmarking; special provisions; reporting; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major programs, which are identified in the schedule of federal awards.

*d.* Management has complied, in all material respects, with the requirements in connection with federal awards except as disclosed to the auditor.

*e.* Information presented in federal financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared.

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[26] These representations may be added to a representation letter obtained in connection with an audit of financial statements instead of obtaining a separate letter.

*f.* Amounts claimed for reimbursement or used for matching were determined in accordance with OMB and agency requirements.

*g.* Management has monitored subrecipients to determine that they have expended financial assistance in accordance with applicable laws and regulations and have met the requirements of Circular A-133 or other applicable federal audit requirements.

*h.* Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.

*i.* Management has considered the results of the subrecipient's audits and made any necessary adjustments to the entity's own books and records.

*j.* Management has identified and disclosed to the auditor all amounts questioned, any known noncompliance with requirements that could have a material effect on a major program, and any other known noncompliance with the specific and general requirements of federal awards.

*k.* Management is responsible for complying with requirements in Circular A-133.

*l.* Management has disclosed all contracts or other agreements with the NPO's service organization.

*m.* Management has disclosed to the auditor all communications from the NPO's service organization relating to noncompliance at the NPO's service organization.

*n.* Management has disclosed whether, subsequent to the date as of which compliance is audited, any changes in the internal control structure or other factors that might significantly affect the internal control structure, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred.

**6.85.** Management's refusal to furnish written representation constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the institution's compliance with Circular A-133 requirements. Further, the auditor should consider the effects that management's refusal will have on his or her ability to rely on other management representations.

# Chapter 7

# REPORTING

## Chapter Overview

7.1 *Government Auditing Standards* and OMB Circular A-133 broaden the auditor's responsibility to include reporting not only on an organization's financial statements but also on its internal control structure and its compliance with laws and regulations and with provisions of contracts and grant agreements. This chapter presents the required compliance reports and the auditor's consideration of the internal control structure in audits performed in accordance with *Government Auditing Standards* and in those performed in accordance with Circular A-133. A pyramid depicting the reports required by GAAS, GAS, and Circular A-133 appears in exhibit 3 of chapter 1 of this SOP. Auditors need to understand the intended purpose of each report and should tailor the reporting to their specific situations. The standard reports are illustrated in appendix D of this SOP. Modifications to the standard reports for circumstances such as uncertainty are also presented in appendix D Other situations may arise that will require other modifications to these reports. It is not practicable to anticipate all situations that may be encountered by the auditor. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

## Reporting Under *Government Auditing Standards*

7.2. In performing an audit of an entity's financial statements in accordance with *Government Auditing Standards*, the auditor is required, in addition to reporting on whether these statements are fairly presented, to report on compliance with laws, regulations, contracts, and grant agreements and to report on the entity's internal control structure.

### *Reporting on the Basic Financial Statements*

7.3. Financial reporting under *Government Auditing Standards* includes an organization's basic financial statements and the auditor's report on the basic financial statements as required by generally accepted auditing standards.

7.4. Circular A-133 requires the auditor to express an opinion about whether the basic financial statements of an NPO as a whole are presented fairly in conformity with GAAP.[27] The financial statements provide the appropriate funding agency with an understanding of an entity's accounting policies and procedures. When assessing whether the basic financial statements are presented fairly in conformity with GAAP, the auditor should consider whether noncompliance with any federal, state, or local laws would materially affect the statements.

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[27] If an organization prepares its basic financial statements in conformity with a comprehensive basis of accounting other than GAAP, the cognizant audit agency may be contacted to ascertain whether these financial statements will meet the Circular A-133 audit requirement. Reporting guidance for financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP is presented in SAS No. 62.

**7.5.** Paragraph 5.13 of *Government Auditing Standards* requires that the auditor's report on the financial statements state the audit was performed in accordance with generally accepted government auditing standards whenever the report is submitted to comply with a legal, regulatory, or contractual requirement for a GAS audit.

**7.6.** *Government Auditing Standards* requires auditors to report on compliance with laws, regulations, contracts, and grant agreements and internal controls in the report on the financial statements or in separate reports. When auditors report separately on compliance and controls, the report on the financial statements should state that they are issuing those additional reports.

## *Reporting on the Internal Control Structure*

**7.7.** Both *Government Auditing Standards* and SAS No. 60 require the communication of reportable conditions noted in an audit. However, *Government Auditing Standards* differs from GAAS in that GAS requires reporting in written form on the internal control structure in all audits, regardless of whether reportable conditions are noted. When reporting on the internal control structure, the auditor should complete the level of audit work required by SAS No. 55. It should be noted that beyond reporting on the internal control structure, GAS requires no more work on the internal control structure than does GAAS. An illustrative report on the internal control structure is presented in exhibit D-3 of appendix D to this SOP.

**7.8.** The following chart summarizes the differences between SAS No. 60 and GAS.

**How GAS Reporting on the Internal Control Structure Differs From SAS No. 60**

| | *GAS* | *SAS No. 60* |
|---|---|---|
| When is a report issued? | In every audit | When reportable conditions are noted |
| What is the form of reporting? | Written | Oral or written |
| Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses? | Yes | Permitted but not required |

**7.9.** Reporting on the internal control structure under *Government Auditing Standards* is based on the auditor's consideration of the internal control structure as required by SAS No. 55. The report does not express an opinion on the NPO's internal control structure, but rather describes the extent of work performed as required by SAS No. 55. *Government Auditing Standards* also states that the report should include a description of reportable conditions as well as separately identify those reportable conditions that are considered material weaknesses. An example of standard reporting language is presented in exhibit D-3 of appendix D of this SOP, and a modification when there are no material weaknesses and no reportable conditions is shown in note 3 to exhibit D-3 in appendix D of this SOP.

## *Identification of Reportable Conditions*

**7.10.** Reportable conditions are defined in SAS No. 60 as "significant deficiencies in the design or operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data in the financial statements." Although *Government Auditing Standards,* like SAS No. 60, does not require the auditor to search for reportable conditions, the auditor should be aware, during the course of the audit, that such deficiencies may exist.

**7.11.** Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. Note 3 to exhibit D-3 of appendix D to this SOP illustrates a report that an auditor may issue to satisfy the requirements of *Government Auditing Standards* if no reportable conditions are noted during an audit.

## Nonreportable Conditions

**7.12.** If an auditor issues a separate written communication to top management describing "nonreportable conditions," the auditor's report on the internal control structure should refer to that separate communication.

## Reporting on Compliance With Laws and Regulations

**7.13.** *Government Auditing Standards* requires reporting on compliance with laws and regulations that, if violated, could have a direct and material effect on an entity's financial statements. The report, which covers noncompliance other than illegal acts, encompasses federal, state, and local laws and regulations that, if violated, could materially affect the basic financial statements. The auditor will have complied with the requirements of *Government Auditing Standards* by designing the audit to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct effect on the determination of financial statement amounts that are material to the financial statements, as required by SAS No. 53 and SAS No. 54. In addition, the auditor, to comply with *Government Auditing Standards,* has the same responsibility in regard to violations of provisions of grants and contracts as he or she does for detecting illegal acts. Further, if specific information that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements comes to the auditor's attention, he or she should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred. An illustrative report on compliance with laws and regulations is presented in exhibit D-4 of appendix D to this SOP.

**7.14.** *Government Auditing Standards* requires that the auditor's report on compliance include all material instances of noncompliance related to the organization's financial statements or to the program, award, claim, fund, or group of accounts being audited. Immaterial instances of noncompliance are not required to be included in the compliance report but should be reported to the organization in a separate letter.

## Illegal Acts

**7.15.** Illegal acts are violations of laws or government regulations. They may include such matters as falsification of records or reports and misappropriation of funds or other assets. SAS No. 54 discusses the auditor's responsibilities with respect to illegal acts, and chapter 5 of *Government Auditing Standards* provides additional guidance on the reporting of illegal acts.

**7.16.** If the auditor is aware of the occurrence of illegal acts and he or she remains uncertain about whether they will materially affect the financial statements, his or her report on the financial statements should be qualified or a disclaimer of opinion should be issued. Both SAS Nos. 53 and 54 discuss situations in which the independent auditor may wish to consult with legal counsel about withdrawing from an engagement.

### *Audit Committee*

**7.17.** Chapter 5, paragraphs 5.5 through 5.8, of *Government Auditing Standards* requires the auditor to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This communication may be oral or written. Auditors may use an engagement letter to communicate such information. If the information is communicated orally, auditors should document the communication in the working papers. Auditors should communicate the following information:

- *a.* The auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal controls and compliance with laws and regulations
- *b.* The nature of any additional testing of internal controls and compliance required by laws and regulations

To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing reporting on internal controls and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance.

## Reports Required by OMB Circular A-133

**7.18.** Circular A-133 requires the auditor to issue the following reports on an organization's federal awards:

- *a.* Reporting required by *Government Auditing Standards*, as described in paragraphs 7.2 through 7.14 of this SOP
- *b.* A report on a supplementary schedule of the entity's federal awards
- *c.* A report on the internal control structure policies and procedures used in administering federal awards
- *d.* A report on compliance with specific laws and regulations that may have a direct and material effect on each major program
- *e.* A report on compliance with certain laws and regulations applicable to nonmajor programs
- *f.* A report on compliance with general requirements

### *The Auditor's Report on the Schedule of Federal Awards*

**7.19.** The recipient or subrecipient of an award is responsible for preparing a schedule of federal awards. Chapter 4 of this SOP describes the presentation requirements governing the schedule. A report on the schedule of federal awards is presented in exhibit D-2 of appendix D to this SOP.

### *Additional Schedules*

**7.20.** Circular A-133 does not require recipients to provide additional schedules such as a schedule of indirect costs. Although not required, the recipient may include any additional information that will make the reports more useful to the federal agencies. For example, a federal agency may need a schedule of indirect costs in lieu of performing a separate audit. In this case, it may be mutually beneficial for the NPO to include the schedule as part of the report.

## The Auditor's Report on the Internal Control Structure Used in Administering Federal Awards

**7.21.** Circular A-133 expands on *Government Auditing Standards* and requires that the auditor determine and report whether an NPO has an internal control structure to provide reasonable assurance that it is managing its federal awards in compliance with applicable laws and regulations. The auditor's report should include—

- If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements.
- A description of the scope of work performed to obtain an understanding of the internal control structure, to assess control risk, and to test the internal control structure policies and procedures.
- A description of the NPO's significant control policies and procedures established to provide reasonable assurance that it is managing its federal awards in compliance with applicable laws and regulations.
- Any reportable conditions noted, including the identification of material weaknesses.

It should be noted that these requirements exceed the minimum requirement of SAS No. 55 to understand the internal control structure and assess control risk in that they require the auditor to test the internal control structure policies and procedures related to federal awards. An illustrative report on the internal control structure used in administering federal awards is presented in exhibit D-8 of appendix D to this SOP.

**7.22.** Circular A-133 states that "tests of controls will not be required for those areas where internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance." Such a situation is a reportable condition. In addition, Circular A-133 states that if the auditor limits his or her consideration of the internal control structure for any reason, the circumstances should be disclosed in the auditor's report on the internal control structure.

## The Auditor's Report on Compliance With Laws and Regulations Related to Major Programs

**7.23.** *Uncertainties and Scope Limitations.* Testing an entity's compliance with general and specific compliance requirements demands that auditors make a comply/noncomply decision about an entity's adherence to those laws and regulations. Circular A-133 requires the auditor to express an opinion about whether the NPO has complied with laws and regulations that may have a direct and material effect on each of its major programs. To comply with this requirement, the auditor should provide an opinion about whether each major program is in compliance, in all material respects, with the specific requirements identified in the report. The report makes reference to any immaterial instances of noncompliance with specific requirements that are included in the schedule of findings and questioned costs or in a separate communication to the management of the NPO. If there are no such immaterial instances of noncompliance, the auditor may so note in the report. If a comply/noncomply decision cannot be made because the auditor is prevented from performing sufficient procedures by the client or by other circumstances, a scope limitation, not an uncertainty, would exist. When an instance of noncompliance has occurred but the resolution of the noncompliance is not known, an uncertainty would exist. The following situations could occur when the auditor is reporting on the results of compliance testing:

- If appropriate evidence cannot be examined to support the comply/noncomply decision, a scope limitation would exist and the audit report would need to be modified. (For illustrations of such reports, see exhibit D-10 in appendix D to this SOP.) However, if the auditor concludes that compliance with a requirement cannot be reasonably estimated or measured, the auditor would be precluded from issuing an opinion on compliance with a specific requirement (see exhibit D-14 in appendix D to this SOP).
- If the auditor examined sufficient evidence to support a noncompliance finding, a modification to the auditor's report on compliance should be considered in light of several factors, including the number and type of instances of noncompliance, determinability of questioned costs, and materiality of questioned costs. If, after considering these factors, the auditor—
  - Believes the instance of noncompliance has a material effect on a federal program, the auditor's report should be modified-qualified or adverse (see exhibits D-11 and D-12 in appendix D to this SOP)
  - Cannot determine whether the instance of noncompliance could have a material effect on the program, an uncertainty exists. Accordingly, the report on compliance should state that noncompliance occurred but that the effect on the federal award program cannot presently be determined. The auditor also should consider the effect of uncertainties associated with federal programs on the basic financial statements and modify that report if necessary (see exhibit D-14 in appendix D to this SOP).

Illustrative reports on compliance with laws and regulations related to major programs are presented in appendix D to this SOP as follows:

| *Exhibit* | *Nature of Report* |
|---|---|
| D-9 | Unqualified opinion |
| D-10 | Qualified opinion—scope limitation |
| D-11 | Qualified opinion—noncompliance |
| D-12 | Adverse opinion |
| D-13 | Disclaimer of opinion |
| D-14 | Uncertainties |

### *Reporting on Compliance With General Requirements*

**7.24.** Circular A-133 requires the auditor to issue a report on compliance with general requirements regardless of whether the organization being audited has major programs. The auditor is not required to issue an opinion on compliance with the general requirements; rather, the auditor should issue a report on the results of procedures used to test compliance with the general requirements. An illustrative report on compliance with the general requirements is presented in exhibit D-15 of appendix D to this SOP.

### *Reporting on Compliance With Specific Requirements Applicable to Nonmajor Program Transactions*

**7.25.** Circular A-133 requires the auditor to issue a report on nonmajor programs that provides "a statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested." The auditor may have selected transactions from nonmajor programs for testing in connection with the audit of the financial statements or the consideration of the internal control structure. As noted in chapter 6, if the auditor has selected such transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions. The auditor need not test for compliance with the general requirements or the specific requirements that apply to the program as a whole, such as matching and reporting requirements. If the auditor has not selected any nonmajor program transactions, or if the entity has no nonmajor programs, no report is required. An illustrative report on compliance with nonmajor program requirements is presented in exhibit D-18 of appendix D to this SOP.

## Dating of Reports

**7.26.** Since the report on the Schedule of Federal Awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as the report on these basic financial statements. Furthermore, since the reports on compliance with laws and regulations and provisions of contracts and grant agreements and on the internal control structure, as required by *Government Auditing Standards*, relate to the basic financial statements and are based on audit procedures performed, they should also be dated the same date as the report on the basic financial statements.

**7.27.** Ideally, the reports required by OMB Circular A-133 should also be dated the same as the other reports, but they often carry a later date because some of the audit work necessary to satisfy the Circular A-133 audit requirements may be done subsequent to the work on the basic financial statements. In any case, when issuing the report on the basic financial statements, the auditor should consider the effect of any material contingent liabilities resulting from possible noncompliance in accordance with FASB Statement No. 5. If, after issuing the report on the basic financial statements, the auditor discovers instances of noncompliance that materially affect the statements, he or she should follow the guidance in AICPA, *Professional Standards*, vol. 1, AU secs. 560 and 561.

## Combined Reporting

**7.28.** The reports issued to comply with the reporting requirements of Circular A-133 involve varying levels of materiality and different forms of reporting. Although it may be feasible in some circumstances to combine certain of the reports, it is difficult to combine them without making them very long and confusing. In addition, the PCIE Desk Review Checklist is designed to review each of the seven individual reports. Accordingly, auditors are strongly discouraged from issuing combined reports.

## Schedule of Findings and Questioned Costs

**7.29.** Circular A-133 requires that the auditor's report on compliance include a summary of material findings of noncompliance and an identification of total amounts questioned as a result of noncompliance, if any, for each federal award and the corrective action recommended by the auditor. Immaterial findings may be included in a schedule of findings and questioned costs or in a separate communication to the management of the NPO.

**7.30.** According to Circular A-133 and *Government Auditing Standards*, in reporting material instances of noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. The extent of material non-compliance should be considered in relation to the number and dollar amount of transactions tested, the size of the population in terms of number of items and dollars, its likely impact on questioned costs, and the dollar amount questioned in order to give the reader a context within which to judge the extent of noncompliance. The auditor's report on compliance should include a summary of all material instances (findings) of noncompliance and identify total amounts questioned, if any, for each federal award. A table may be an appropriate method of summarizing extensive findings.

**7.31.** In presenting the findings, the auditor should refer to the guidance on report contents and report presentation in paragraphs 9 through 65 of chapter 7 of *Government Auditing Standards*, although these relate specifically to performance rather than financial audits. That guidance suggests that well-developed findings are those that provide sufficient information to federal, state, and local officials to permit timely and corrective action. Findings generally consist of statements of the conditions (what is), criteria (what should be), effect (the difference between what is and what should be), and cause (why it happened). PCIE Position Statement No. 6, Question 41, states that the following specific information should be included in findings:

- The award name, award number, grantor, CFDA number, and grant year
- The condition found, including facts relied on that indicate that noncompliance occurred
- Specific requirement for which noncompliance is found, including regulatory, statutory, or other citation
- Identification of the questioned costs and how they were computed
- The cause of the noncompliance
- Recommendation for corrective action to prevent future occurrences of noncompliance
- Pertinent views of responsible officials of the audited entity concerning the finding and what corrective action is planned
- Other information necessary to determine the cause and effect in order to take proper corrective action

## *Views of Responsible Officials (Organization's Comments)*

**7.32.** The subsection entitled "Views of Responsible Officials" in paragraphs 7.38 through 7.42 of *Government Auditing Standards* states: "Auditors should report the views of responsible officials of the audited program concerning auditors' findings, conclusions, and recommendations, as well as corrections planned." Normally, these views would be presented in the recipient's comments on the auditor's findings and recommendations in accordance with paragraph 15(g) of Circular A-133.

**7.33.** The comments should include a statement by responsible officials of the audited organization concerning their agreement with the findings, conclusions, and recommendations reported. If the organization disagrees with the findings, conclusions, and recommendations and the auditor concludes that they are valid, a rebuttal to the organization's comments addressing the reasons why the auditor has not changed the findings, conclusions, and recommendations should be included in the schedule of findings and questioned costs. The presentation of views is separate from the organization's corrective action plan, which it submits directly to the sponsor or cognizant agency.

## *Audit Resolution*

**7.34.** The first step in resolving audit findings is for the organization to respond to the auditor's findings and recommendations. The response will normally be in the form of a written corrective action plan and should include who will take what corrective action by what date. The organization should indicate and provide reasons when it does not agree with the auditor's findings or does not think corrective action is necessary. The corrective action plan should be submitted with the audit report, which is due within thirty days after completion of the audit.

**7.35** As noted in PCIE Position Statement No. 6, Question 45, the federal agencies responsible for audit resolution will evaluate the auditor's findings and recommendations along with the NPO's corrective action plan. Each federal agency responsible for audit resolution is required to issue a management decision within six months of receipt of the audit report. The management decision is the federal agency's response to the auditor's findings and the NPO's corrective action plan. A management decision can include additional actions necessary to resolve the findings.

**7.36.** Resolution normally occurs when the federal agency responds with a management decision. Upon learning of the finding, the NPO should proceed with corrective action as rapidly as possible.

**7.37.** Resolution of findings that relate to the programs of a single federal agency is the responsibility of that agency. Resolution of findings affecting programs of more than one federal agency is coordinated by the cognizant agency. A prime recipient is required to ensure that appropriate corrective action is taken by a subrecipient.

**7.38.** Sanctions such as disallowed costs, or withholding or suspending awards, are available to federal agencies when proper corrective action on audit findings is not made in a timely manner.

**7.39.** Findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work. Appendix F of this SOP includes illustrations of the reporting of noncompliance.

## *Audit Follow-Up (Status of Prior Audit Findings)*

**7.40.** Section 2.i of Attachment F to Circular A-110 provides that an organization have a systematic method to assure timely and appropriate resolution of audit findings and recommendations. Paragraphs 3.47 and 3.48 of this SOP describe the requirement for audit follow-up in *Government Auditing Standards.* Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

**7.41.** Federal agencies are required to track the status of management's actions on significant or material findings and recommendations from prior audits.

**7.42.** The management of some NPOs advocate routine disclosure of the status of separate grantor audits of grant or entitlement programs. Such disclosure is not necessary in the absence of uncertainties related to claims for refunds asserted in connection with such third-party audits. The auditor should consider the effect of aggregated identified noncompliance on the financial statements when preparing his or her report. FASB Statement No. 5 provides guidance in accounting for and reporting on such matters.

7.43. Some events of noncompliance do not have material financial implications on the financial statements, and disclosure of them, therefore, is not required. Nevertheless, special consideration should be given to those events for purposes of reporting to sponsors or donors and other purposes.

## Submission of Reports

7.44. Circular A-133 requires that copies of the audit reports be submitted in accordance with *Government Auditing Standards.* GAS requires that the audit reports be submitted to the organization being audited and to the appropriate officials of the organizations requiring or arranging for the audits (including external funding organizations) thirty days after the completion of the audit, unless legal restrictions, ethical considerations, or other arrangements prevent such distribution. Subrecipients should submit copies of the audit reports to recipients that provided federal awards.

7.45. The reports are due within thirty days after the completion of the audit, but the audit should be completed and the report submitted no later than thirteen months after the end of the recipient's fiscal year, unless the cognizant or oversight agency agrees to a longer period.

7.46. The NPO is responsible for submitting all reports to each federal agency that provides direct federal funds. Also, subrecipients must distribute copies of reports to all recipients that provide them with federal funds. The report distribution requirements are met when the report is distributed by either the NPO or its auditor. PCIE Position Statement No. 6 includes a schedule of federal agency contact points for Circular A-133 audits.

7.47. The NPO should include with the report a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings.

7.48. Both recipients and subrecipients receiving federal awards over $100,000 are required to send a copy of the report to the central clearinghouse designated by the Office of Management and Budget. The address is:

Federal Audit Clearinghouse
Bureau of the Census
1201 E. 10th Street
Jeffersonville, IN 47132

7.49. While the various auditor's reports may have different dates and may be received by the NPO at different times, they should be delivered together to the cognizant or other oversight agency.

## Program Audit Reporting

7.50. As noted in PCIE Position Statement No. 6, Question 22, in many cases a program-specific audit guide will be available to provide specific guidance on compliance testing, audit procedures, and reporting. The auditor should determine the availability of agency-prepared supplements or audit guides. This can be done by reviewing the *Program Audit Guide Survey* (October 1991) prepared by the PCIE Standards Subcommittee. The survey (order number PCIE-06-064) may be obtained by written request to the Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Ave., NW, Washington, DC 20220 or by FAX to (202) 927-5418.

**7.51.** The auditor may also contact the appropriate Inspector General's Office to determine whether subsequent audit guides have been issued or to obtain a copy of an audit guide. When a current program-specific audit guide is not available, the auditor may obtain guidance from the program laws and regulations, grant agreements, and the Compliance Supplements.

**7.52.** Program-specific audits for which no current federal agency audit guide is available must conform to the reporting required by *Government Auditing Standards*. The reporting should normally include an opinion on the financial statements of the program, a report on the program's internal controls, and a report on program compliance with laws and regulations. A schedule of findings and questioned costs, management letter, or report on illegal acts may also be required when applicable.

**7.53.** A program audit may usually be performed on either the NPO fiscal year or the award year. However, for first-time audits or changes to existing audit periods, the auditor should contact the grantor agency or review the program audit guide, laws, and regulations concerning the proper audit period.

## *Stub Periods*

**7.54.** Stub periods may occur when converting from one type of audit to another or when changing audit periods. Arrangements should be made to meet audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including federal expenditures during the stub period with the Circular A-133 audit. The cognizant, oversight, or grantor agency should be contacted for advice on audit procedures for stub periods.

## *Freedom of Information Act*

**7.55.** In accordance with the principles of the Freedom of Information Act (Title 5 of U.S. Code Section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that information contained in them is not subject to exemptions of the Act that the cognizant agency chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

# APPENDIX A

# OMB Circular A-133

## SUBJECT: Audits of Institutions of Higher Education and Other Nonprofit Organizations

1. *Purpose.* Circular A-133 establishes audit requirements and defines Federal responsibilities for implementing and monitoring such requirements for institutions of higher education and other nonprofit institutions receiving Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; Reorganization Plan No. 2 of 1970; and Executive Order No. 11541.

3. *Supersession.* Circular A-133 supersedes Attachment F, subparagraph 2h, of Circular A-110, "Uniform Administrative Requirements for Grants and other Agreements with Institutions of Higher Education, Hospitals, and other Nonprofit Organizations."

4. *Applicability.* The provisions of Circular A-133 apply to:

   *a.* Federal departments and agencies responsible for administering programs that involve grants, cost-type contracts and other agreements with institutions of higher education and other nonprofit recipients.

   *b.* Nonprofit institutions, whether they are recipients, receiving awards directly from Federal agencies, or are sub-recipients, receiving awards indirectly through other recipients.

These principles, to the extent permitted by law, constitute guidance to be applied by agencies consistent with and within the discretion, conferred by the statutes governing agency action.

5. *Requirements and Responsibilities.* The specific requirements and responsibilities of Federal departments and agencies and institutions of higher education and other nonprofit institutions are set forth in the attachment.

6. *Effective Date.* The provisions of Circular A-133 are effective upon publication and shall apply to audits of nonprofit institutions for fiscal years that begin on or after January 1, 1990. Earlier implementation is encouraged. However, until this Circular is implemented, the audit provisions of Attachment F to Circular A-110 shall continue to be observed.

7. *Policy Review (Sunset) Date.* Circular A-133 will have a policy review three years from the date of issuance.

8. *Inquiries.* Further information concerning Circular A-133 may be obtained by contacting the Financial Management Division, Office of Management and Budget, Washington, D.C. 20503, telephone (202) 395-3993.

Richard G. Darman
Director

# ATTACHMENT

1. ***Definitions***. For the purposes of this Circular, the following definitions apply:

*a.* "Award" means financial assistance, and Federal cost-type contracts used to buy services or goods for the use of the Federal Government. It includes awards received directly from the Federal agencies or indirectly through recipients. It does not include procurement contracts to vendors under grants or contracts, used to buy goods or services. Audits of such vendors shall be covered by the terms and conditions of the contract.

*b.* "Cognizant agency" means the Federal agency assigned by the Office of Management and Budget to carry out the responsibilities described in paragraph 3 of this Attachment.

*c.* "Coordinated audit approach" means an audit wherein the independent auditor, and other Federal and non-federal auditors consider each other's work, in determining the nature, timing, and extent of his or her own auditing procedures. A coordinated audit must be conducted in accordance with *Government Auditing Standards* and meet the objectives and reporting requirements set forth in paragraphs 12(*b*) and 15, respectively, of this Attachment. The objective of the coordinated audit approach is to minimize duplication of audit effort, but not to limit the scope of the audit work so as to preclude the independent auditor from meeting the objectives set forth in paragraph 12(*b*) or issuing the reports required in paragraph 15 in a timely manner.

*d.* "Federal agency" has the same meaning as the term 'agency' in Section 551(1) of Title 5, United States Code.

*e.* "Federal Financial Assistance."

(1) "Federal financial assistance" means assistance provided by a Federal agency to a recipient or subrecipient to carry out a program. Such assistance may be in the form of:

— grants;

— contracts;

— cooperative agreements;

— loans;

— loan guarantees;

— property;

— interest subsidies;

— insurance;

— direct appropriations;

— other non-cash assistance.

(2) Such assistance does not include direct Federal cash assistance to individuals.

(3) Such assistance includes awards received directly from Federal agencies, or indirectly when sub-recipients receive funds identified as Federal funds by recipients.

(4) The granting agency is responsible for identifying the source of funds awarded to recipients; the recipient is responsible for identifying the source of funds awarded to sub-recipients.

*f.* "Generally accepted accounting principles" has the meaning specified in the *Government Auditing Standards.*

*g.* "Independent auditor" means:

(1) A Federal, State, or local government auditor who meets the standards specified in the *Government Auditing Standards*; or

(2) A public accountant who meets such standards.

*h.* "Internal control structure" means the policies and procedures established to provide reasonable assurance that:

(1) Resource use is consistent with laws, regulations, and award terms;

(2) Resources are safeguarded against waste, loss, and misuse; and

(3) Reliable data are obtained, maintained, and fairly disclosed in reports.

*i.* "Major program" means an individual award or a number of awards in a category of Federal assistance or support for which total expenditures are the larger of three percent of total Federal funds expended or $100,000, on which the auditor will be required to express an opinion as to whether the major program is being administered in compliance with laws and regulations. Each of the following categories of Federal awards shall constitute a major program where total expenditures are the larger of three percent of total Federal funds expended or $100,000:

— Research and Development.

— Student Financial Assistance.

— Individual awards not in the student aid or research and development category.

*j.* "Management decision" means the evaluation by the management of an establishment of the findings and recommendations included in an audit report and the issuance of a final decision by management concerning its response to such findings and recommendations, including actions concluded to be necessary.

*k.* "Nonprofit institution" means any corporation, trust, association, cooperative or other organization which (1) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest; (2) is not organized primarily for profit; and (3) uses its net proceeds to maintain, improve, and/or expand its operations. The term "nonprofit institutions" includes institutions of higher education, except those institutions that are audited as part of single audits in accordance with Circular A-128 "Audits of State and Local Governments." The term does not include hospitals which are not affiliated with an institution of higher education, or State and local governments and Indian tribes covered by Circular A-128 "Audits of State and Local Governments."

*l.* "Oversight" agency means the Federal agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency, unless no direct funding is received. Where there is no direct funding, the Federal agency with the predominant indirect funding will assume the general oversight responsibilities. The duties of the oversight agency are described in paragraph 4 of this Attachment.

*m.* "Recipient" means an organization receiving financial assistance to carry out a program directly from Federal agencies.

*n.* "Research and development" includes all research activities, both basic and applied, and all development activities that are supported at universities, colleges, and other nonprofit institutions. "Research" is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. "Development" is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

*o.* "Student Financial Assistance" includes those programs of general student assistance in which institutions participate, such as those authorized by Title IV of the Higher Education Act of 1965 which is administered by the U.S. Department of Education and similar programs provided by other Federal agencies. It does not include programs which provide fellowships of similar awards to students on a competitive basis, or for specified studies or research.

*p.* "Sub-recipient" means any person or government department, agency, establishment, or nonprofit organization that receives financial assistance to carry out a program through a primary recipient or other sub-recipient, but does not include an individual that is a beneficiary of such a program. A sub-recipient may also be a direct recipient of Federal awards under other agreements.

*q.* "Vendor" means an organization providing a recipient or sub-recipient with generally required goods or services that are related to the administrative support of the Federal assistance program.

**2. *Audit of Nonprofit Institutions.***

*a.* *Requirements Based on Awards Received.*

(1) Nonprofit institutions that receive $100,000 or more a year in Federal awards shall have an audit made in accordance with the provisions of this Circular. However, nonprofit institutions receiving $100,000 or more but receiving awards under only one program have the option of having an audit of their institution prepared in accordance with the provisions of the Circular or having an audit made of the one program. For prior or subsequent years, when an institution has only loan guarantees or outstanding loans that were made previously, the institution may be required to conduct audits for those programs, in accordance with regulations of the Federal agencies providing those guarantees or loans.

(2) Nonprofit institutions that receive at least $25,000 but less than $100,000 a year in Federal awards shall have an audit made in

accordance with this Circular or have an audit made of each Federal award, in accordance with Federal laws and regulations governing the programs in which they participate.

(3) Nonprofit institutions receiving less than $25,000 a year in Federal awards are exempt from Federal audit requirements, but records must be available for review by appropriate officials of the Federal grantor agency or subgranting entity.

*b. Oversight by Federal Agencies.*

(1) To each of the larger nonprofit institutions the Office of Management and Budget (OMB) will assign a Federal agency as the cognizant agency for monitoring audits and ensuring the resolution of audit findings that affect the programs of more than one agency.

(2) Smaller institutions not assigned a cognizant agency will be under the general oversight of the Federal agency that provides them with the most funds.

(3) Assignments to Federal cognizant agencies for carrying out responsibilities in this section are set forth in a separate supplement to this Circular.

(4) Federal Government-owned, contractor-operated facilities at institutions or laboratories operated primarily for the Government are not included in the cognizance assignments. These will remain the responsibility of the contracting agencies. The listed assignments cover all of the functions in this Circular unless otherwise indicated. The Office of Management and Budget will coordinate changes in agency assignments.

3. ***Cognizant Agency Responsibilities***. A cognizant agency shall:

*a.* Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of this Circular.

*b.* Provide technical advice and liaison to institutions and independent auditors.

*c.* Obtain or make quality control reviews of selected audits made by non-Federal audit organizations, and provide the results, when appropriate, to other interested organizations.

*d.* Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any reported illegal acts or irregularities. A cognizant agency should also inform State or local law enforcement and prosecuting authorities, if not advised by the recipient, of any violation of law within their jurisdiction.

*e.* Advise the recipient of audits that have been found not to have met the requirements set forth in this Circular. In such instances, the recipient will work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and Federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies for disciplinary action.

*f.* Coordinate, to the extent practicable, audits or reviews made for Federal agencies that are in addition to the audits made pursuant to this Circular, so that the additional audits or reviews build upon audits performed in accordance with the Circular.

*g.* Ensure the resolution of audit findings that affect the programs of more than one agency.

*h.* Seek the views of other interested agencies before completing a coordinated program.

*i.* Help coordinate the audit work and reporting responsibilities among independent public accountants, State auditors, and both resident and non-resident Federal auditors to achieve the most cost-effective audit.

4. ***Oversight Agency Responsibilities***. An oversight agency shall provide technical advice and counsel to institutions and independent auditors when requested by the recipient. The oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency.

5. ***Recipient Responsibilities***. A recipient that receives a Federal award and provides $25,000 or more of it during its fiscal year to a sub-recipient shall:

*a.* Ensure that the nonprofit institution sub-recipients that receive $25,000 or more have met the audit requirements of this Circular, and that sub-recipients subject to OMB Circular A-128 have met the audit requirements of that Circular;

*b.* Ensure that appropriate corrective action is taken within six months after receipt of the sub-recipient audit report in instances of noncompliance with Federal laws and regulations;

*c.* Consider whether sub-recipient audits necessitate adjustment of the recipient's own records; and

*d.* Require each sub-recipient to permit independent auditors to have access to the records and financial statements as necessary for the recipient to comply with this Circular.

6. ***Relation to Other Audit Requirements.***

*a.* An audit made in accordance with this Circular shall be in lieu of any financial audit required under individual Federal awards. To the extent that an audit made in accordance with this Circular provides Federal agencies with the information and assurances they need to carry out their overall responsibilities, they shall rely upon and use such information. However, a Federal agency shall make any additional audits or reviews necessary to carry out responsibilities under Federal law and regulation. Any additional Federal audits or reviews shall be planned and carried out in such a way as to build upon work performed by the independent auditor.

*b.* Audit planning by Federal audit agencies should consider the extent to which reliance can be placed upon work performed by other auditors. Such auditors include State, local, Federal, and other independent auditors, and a recipient's internal auditors. Reliance placed upon the work of other auditors should be documented and in accordance with *Government Auditing Standards*.

*c.* The provisions of this Circular do not limit the authority of Federal agencies to make or contract for audits and evaluations of Federal awards, nor do they limit the authority of any Federal agency Inspector General or other Federal official.

*d.* The provisions of this Circular do not authorize any institution or sub-recipient thereof to constrain Federal agencies, in any manner, from carrying out additional audits, evaluations or reviews.

*e.* A Federal agency that makes or contracts for audits, in addition to the audits made by recipients pursuant to this Circular, shall, consistent with other applicable laws and regulations, arrange for funding the cost of such additional audits. Such additional audits or reviews include financial, performance audits and program evaluations.

7. ***Frequency of Audit.*** Audits shall usually be performed annually but not less frequently than every two years.

8. ***Sanctions.*** No audit costs may be charged to Federal awards when audits required by this Circular have not been made or have been made but not in accordance with this Circular. In cases of continued inability or unwillingness to have a proper audit in accordance with the Circular, Federal agencies must consider appropriate sanctions including:

— withholding a percentage of awards until the audit is completed satisfactorily;

— withholding or disallowing overhead costs; or

— suspending Federal awards until the audit is made.

9. ***Audit Costs.*** The cost of audits made in accordance with the provisions of this Circular are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, determined in accordance with the provisions of Circular A-21, "Cost Principles for Universities" or Circular A-122, "Cost Principles for Nonprofit Organizations," FAR Subpart 31, or other applicable cost principles or regulations.

10. ***Auditor Selection.*** In arranging for audit services institutions shall follow the procurement standards prescribed by Circular A-110, "Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and other Nonprofit Organizations."

11. ***Small and Minority Audit Firms.***

*a.* Small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals shall have the maximum practicable opportunity to participate in contracts awarded to fulfill the requirements of this Circular.

*b.* Recipients of Federal awards shall take the following steps to further this goal:

(1) Ensure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals are used to the fullest extent practicable;

(2) Make information on forthcoming opportunities available and arrange timeframes for the audit to encourage and facilitate participation by small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals;

(3) Consider in the contract process whether firms competing for larger audits intend to subcontract with small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals;

(4) Encourage contracting with small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals which have traditionally audited government programs, and in cases where this is not possible, assure that these firms are given consideration for audit subcontracting opportunities;

(5) Encourage contracting with consortiums of small audit firms as described in section (1), above, when a contract is too large for an individual small audit firm or audit firm owned and controlled by socially and economically disadvantaged individuals; and

(6) Use the services and assistance, as appropriate, of such organizations as the Small Business Administration in the solicitation and utilization of small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals.

**12. *Scope of Audit and Audit Objectives.***

*a.* The audit shall be made by an independent auditor in accordance with *Government Auditing Standards* developed by the Comptroller General of the United States covering financial audits. An audit under this Circular should be an organization-wide audit of the institution. However, there may be instances where Federal auditors are performing audits or are planning to perform audits at nonprofit institutions. In these cases, to minimize duplication of audit work, a coordinated audit approach may be agreed upon between the independent auditor, the recipient and the cognizant agency or the oversight agency. Those auditors who assume responsibility for any or all of the reports called for by paragraph 15 should follow guidance set forth in *Government Auditing Standards* in using work performed by others.

*b.* The auditor shall determine whether:

(1) The financial statements of the institution present fairly its financial position and the results of its operations in accordance with generally accepted accounting principles;

(2) The institution has an internal control structure to provide reasonable assurance that the institution is managing Federal awards in compliance with applicable laws and regulations, and controls that ensure compliance with the laws and regulations that could have a material impact on the financial statements; and

(3) The institution has complied with laws and regulations that may have a direct and material effect on its financial statement amounts and on each major Federal program.

**13. *Internal Controls Over Federal Awards; Compliance Reviews.***

*a.* *General.* The independent auditor shall determine and report on whether the recipient has an internal control structure to provide reasonable assurance that it is managing Federal awards in compliance with applicable laws, regulations, and contract terms, and that it safeguards Federal funds. In performing these reviews, independent auditors should rely upon work performed by a recipient's internal auditors to the maximum extent possible. The extent of such reliance should be based upon the *Government Auditing Standards*.

*b.* *Internal Control Review.*

(1) In order to provide this assurance on internal controls, the auditor must obtain an understanding of the internal control structure and assess levels of internal control risk. After obtaining an understanding of the controls, the assessment must be made whether or not the auditor intends to place reliance on the internal control structure.

(2) As part of this review, the auditor shall:

(*a*) Perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Tests of controls will not be required for those areas where the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance, in which case a reportable condition or a material weakness should be reported in accordance with paragraph 15*c*(2) of this Circular.

(*b*) Review the recipient's system for monitoring sub-recipients and obtaining and acting on sub-recipient audit reports.

(*c*) Determine whether controls are in effect to ensure direct and indirect costs were computed and billed in accordance with the guidance provided in the general requirements section of the compliance supplement to this Circular.

*c.* *Compliance Review.*

(1) The auditor shall determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. In addition, transactions selected for nonmajor programs shall be tested for compliance with Federal laws and regulations that apply to such transactions.

(2) In order to determine which major programs are to be tested for compliance, recipients shall identify, in their accounts, all Federal funds received and expended and the programs under which they were received. This shall include funds received directly from Federal agencies, through other state and local governments or other recipients. To assist recipients in identifying Federal awards, Federal agencies and primary recipients shall provide the CFDA numbers to the recipients when making the awards.

(3) The review must include the selection of an adequate number of transactions from each major Federal financial assistance program so that the auditor obtains sufficient evidence to support the opinion on compliance required by paragraph 15c(3) of this

Attachment. The selection and testing of transactions shall be based on the auditors' professional judgment considering such factors as the amount of expenditures for the program; the newness of the program or changes in its conditions; prior experience with the program particularly as revealed in audits and other evaluations (e.g., inspections, program reviews, or system reviews required by FAR); the extent to which the program is carried out through sub-recipients; the extent to which the program contracts for goods or services; the level to which the program is already subject to program reviews or other forms of independent oversight; the adequacy of the controls for ensuring compliance; the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

(4) In making the test of transactions, the auditor shall determine whether:

- the amounts reported as expenditures were for allowable services, and
- the records show that those who received services or benefits were eligible to receive them.

(5) In addition to transaction testing, the auditor shall determine whether:

- matching requirements, levels of effort and earmarking limitations were met,
- Federal financial reports and claims for advances and reimbursement contain information that is supported by books and records from which the basic financial statements have been prepared, and
- amounts claimed or used for matching were determined in accordance with (1) OMB Circular A-21, "Cost Principles for Educational Institutions"; (2) matching or cost sharing requirements in Circular A-110, "Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations"; (3) Circular A-122, "Cost Principles for Nonprofit Organizations"; (4) FAR subpart 31 cost principles; and (5) other applicable cost principles or regulations.

(6) The principal compliance requirements of the largest Federal programs may be ascertained by referring to the *"Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-profit Institutions,"* and the *"Compliance Supplement for Single Audits of State and Local Governments,"* issued by OMB and available from the Government Printing Office. For those programs not covered in the Compliance Supplements, the auditor should ascertain compliance requirements by reviewing the statutes, regulations, and agreements governing individual programs.

(7) Transactions related to other awards that are selected in connection with examinations of financial statements and evaluations of internal controls shall be tested for compliance with Federal laws and regulations that apply to such transactions.

14. ***Illegal Acts***. If, during or in connection with the audit of a nonprofit institution, the auditor becomes aware of illegal acts, such acts shall be reported in accordance with the provisions of the *Government Auditing Standards*.

15. ***Audit Reports***.

*a*. Audit reports must be prepared at the completion of the audit.

*b*. The audit report shall state that the audit was made in accordance with the provisions of this Circular.

*c*. The report shall be made up of at least the following three parts:

(1) The financial statements and a schedule of Federal awards and the auditor's report on the statements and the schedule. The schedule of Federal awards should identify major programs and show the total expenditures for each program. Individual major programs other than Research and Development and Student Aid should be listed by catalog number as identified in the *Catalog of Federal Domestic Assistance*. Expenditures for Federal programs other than major programs shall be shown under the caption "other Federal assistance." Also, the value of non-cash assistance such as loan guarantees, food commodities or donated surplus properties or the outstanding balance of loans should be disclosed in the schedule.

(2) A written report of the independent auditor's understanding of the internal control structure and the assessment of control risk. The auditor's report should include as a minimum: (1) the scope of the work in obtaining understanding of the internal control structure and in assessing the control risk, (2) the nonprofit institution's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements and those that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations, and (3) the reportable conditions, including the identification of material weaknesses, identified as a result of the auditor's work in understanding and assessing the control risk. If the auditor limits his/her consideration of the internal control structure for any reason, the circumstances should be disclosed in the report.

(3) The auditor's report on compliance containing:

— An opinion as to whether each major Federal program was being administered in compliance with laws and regulations applicable to the matters described in paragraph 13*c*(3) of this Attachment, including compliance with laws and regulations pertaining to financial reports and claims for advances and reimbursements;

— A statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested;

— Material findings of noncompliance presented in their proper perspective:

- The size of the universe in number of items and dollars,

- The number and dollar amount of transactions tested by the auditors,
- The number and corresponding dollar amount of instances of noncompliance,

— Where findings are specific to a particular Federal award, an identification of total amounts questioned, if any, for each Federal award, as a result of noncompliance and the auditor's recommendations for necessary corrective action.

*d.* The three parts of the audit report may be bound into a single document, or presented at the same time as separate documents.

*e.* Nonmaterial findings need not be disclosed with the compliance report but should be reported in writing to the recipient in a separate communication. The recipient, in turn, should forward the findings to the Federal grantor agencies or subgrantor sources.

*f.* All fraud or illegal acts or indications of such acts, including all questioned costs found as the result of these acts that auditors become aware of, may be covered in a separate written report submitted in accordance with the *Government Auditing Standards.*

*g.* The auditor's report should disclose the status of known but uncorrected significant material findings and recommendations from prior audits that affect the current audit objective as specified in the *Government Auditing Standards.*

*h.* In addition to the audit report, the recipient shall provide a report of its comments on the findings and recommendations in the report, including a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. If corrective action is not necessary, a statement describing the reason it is not should accompany the audit report.

*i.* Copies of the audit report shall be submitted in accordance with the reporting standards for financial audits contained in the *Government Auditing Standards.* Sub-recipient auditors shall submit copies to recipients that provided Federal awards. The report shall be due within 30 days after the completion of the audit, but the audit should be completed and the report submitted not later than 13 months after the end of the recipient's fiscal year unless a longer period is agreed to with the cognizant or oversight agency.

*j.* Recipients of more than $100,000 in Federal awards shall submit one copy of the audit report within 30 days after issuance to a central clearinghouse to be designated by the Office of Management and Budget. The clearinghouse will keep completed audit reports on file.

*k.* Recipients shall keep audit reports, including subrecipient reports, on file for three years from their issuance.

**16.** ***Audit Resolution.***

*a.* As provided in paragraph 3, the cognizant agency shall be responsible for ensuring the resolution of audit findings that affect the programs of more than one Federal agency. Resolution of findings that relate to the programs of a single Federal agency will be the responsibility of the recipient and the agency. Alternate arrangements may be made on case-by-case basis by agreement among the agencies concerned.

*b*. A management decision shall be made within six months after receipt of the report by the Federal agencies responsible for audit resolution. Corrective action should proceed as rapidly as possible.

17. ***Audit Workpapers and Reports***. Workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency or its designee or the General Accounting Office, at the completion of the audit.

## APPENDIX B

# Reference Documents for Compliance Auditing of Not-for-Profit Organizations

In the planning stage of the audit, independent auditors should become familiar with the applicable documents presented below. The documents are among the most important ones to be used for verification and reference purposes in auditing compliance for NPOs. Sources for these materials are identified below. The auditor should use the most current reference material that applies to the period under audit.

The AICPA publications listed below may be obtained from the American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881, or by calling 800-862-4272. Federal government publications may be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402 (order desk telephone: 202-783-3238). Standards of the President's Council on Integrity and Efficiency (except for PCIE Position Statement No. 6) can be obtained by writing or faxing the Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Avenue, NW, Washington, DC 20220 (fax: 202-927-5418).

## Cost Principles

*a.* OMB Circular A-21, *Cost Principles for Educational Institutions*

*b.* OMB Circular A-122, *Cost Principles for Nonprofit Organizations*

*c.* OASC-3 (45 CFR, Part 74), *Cost Principles for Hospitals*

## Auditing Standards

*a.* AICPA *Professional Standards*, volume 1, including SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*

*b.* *Government Auditing Standards*, issued by the Comptroller General of the United States (1994 revision)

*c.* *Guide for Review of Sensitive Payments*, published by the General Accounting Office (GAO)

## AICPA Audit and Accounting Guides

*a.* *Not-for-Profit Organizations*

*b.* *Health Care Organizations*

*c.* *Audit Sampling*

*d.* *Consideration of Internal Control in a Financial Statement Audit*

*e.* *Audits of State and Local Governmental Units*

## Office of Management and Budget (OMB) and Other Compliance Guidelines

*a.* OMB Circular A-21, *Cost Principles for Educational Institutions*

*b.* OMB Circular A-73, *Audits of Federal Operations and Programs*

*c.* *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* (October 1991)

*d.* *Compliance Supplement for Single Audits of State and Local Governments* (September 1990)

*e.* *Catalog of Federal Domestic Assistance*

*f.* OMB Circular A-88, *Indirect Cost Rates, Audit and Audit Follow-Up at Educational Institutions*, and successive publications (cognizant audit responsibilities)

*g.* OMB Circular A-110, *Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*

*h.* OMB Circular A-122, *Cost Principles for Nonprofit Organizations*

*i.* OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*

## PCIE Statements and Guidance

*a.* PCIE Statement No. 1 provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.

*b.* PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50 percent rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* should be accepted.

*c.* PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.

*d.* PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.

*e.* PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110.

*f.* PCIE Statement No. 6 (order number 041-001-00374-6) answers commonly asked questions about audits of federal programs under OMB Circular A-133. This can be obtained by contacting the Government Printing Office.

*g.* *Program Audit Guide Survey* was issued by the PCIE Standards Subcommittee (October 1991). One copy can be obtained (order number PCIE-06-064) by writing to the PCIE at:

Department of the Treasury
Office of Inspector General
Room 7210, ICC Bldg.
1201 Constitution Ave., N.W.
Washington, DC 20220

## Sponsors' Guidelines

- *Financial Aid Handbook*, issued by the Department of Education
- PHS *Grants Administration Manual* and *Grants Policy Statement*
- The National Science Foundation's *Grants for Scientific Research*
- AID Handbooks
- Federal Acquisition Regulations (FAR)
- Defense Department Supplement (DFARS)
- Standards of Accounting and Financial Reporting for Voluntary Health & Welfare Organizations, third edition (1988), issued by the National Health Council (commonly referred to as the "black book")
- 1988 Combined Federal Campaign Rule 5 CFR Part 950, *Solicitation of Federal Civilian and Uniformed Service Personnel for Contributions to Private Voluntary Organizations*, issued by the United States Office of Personnel Management.

## Federal Agency Guidance

*Federal Cognizant Agency Audit Organization Guidelines*, issued by the President's Council on Integrity and Efficiency (includes desk and quality control review guides, revised May 1991)

Directory of Inspectors General—List of Federal Agency Contact Points for Single Audit Act Questions and Materials

Federal Agency Implementation of Single Audit Requirements

Department of the Interior

Department of Transportation

Department of Agriculture

Department of Commerce

Veterans Administration

Department of Health and Human Services

Department of Labor

Federal Emergency Management Agency

Department of Education

Department of Housing and Urban Development

Department of Energy

Department of Transportation, Federal Highway Administration

Environmental Protection Agency

*Quality Standards for Federal Offices of Inspector General*, issued by the President's Council on Integrity and Efficiency (Performance Evaluation Committee), January 1986

Common Rule for Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments; Federal Agency Implementation of Common Rule

*A Guide for Roles and Responsibilities in Subrecipient Audits*, issued by Mid-America Intergovernmental Audit Forum

*Review Guide for Long-Form University Indirect Cost Proposals*, issued by U.S. Department of Health and Human Services.

## APPENDIX C

# Engagements to Report on Compliance With Specified Requirements of State and Local Laws, Regulations, Contracts, and Grants

A practitioner may be engaged to express an opinion or perform agreed-upon procedures regarding an organization's compliance with specified requirements of state and local laws, regulations, contracts, and grants. For example, a practitioner may be engaged to express an opinion about a private school's compliance with specific requirements regarding curriculum content or pupil transportation. In such situations, a practitioner should perform an attestation engagement in accordance with Statement on Standards for Attestation Engagements No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), which requires management to present a written assertion about the organization's compliance with the specified requirements.

## APPENDIX D

# Illustrative Audit Reports

The following is a list of the reports illustrated in this appendix:

**Exhibit D-1**

# Unqualified Opinion on Financial Statements

*[Addressee]*

Independent Auditor's Report

We have audited the accompanying statement of financial position of *[name of organization]* as of June 30, 19XX, and the related statements of activities and cash flows for the year then ended.[1] These financial statements are the responsibility of *[name of organization]*'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of *[name of organization]* as of June 30, 19XX, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated *[date of report]* on our consideration of *[name of organization]*'s internal control structure and a report dated *[date of report]* on its compliance with laws and regulations.[3]

*[Signature]*
*[Date]*

*Notes*:

1. References to the financial statements were taken from FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.
2. When reporting on an audit performed in accordance with *Government Auditing Standards* or Circular A-133, the phrase "and *Government Auditing Standards* issued by the Comptroller General of the United States" must be included in the report on the financial statements.

   If the financial statements are issued separately for an audit performed in accordance with *Government Auditing Standards* or Circular A-133, the phrase "and *Government Auditing Standards*, issued by the Comptroller General of the United States" *must* still be included in the report on the financial statements.
3. The report on the financial statements for an audit in accordance with *Government Auditing Standards* may describe the scope of the auditor's testing of compliance with certain provisions of laws, regulations, contracts, and grants, and internal controls and present the results of those tests. If the report on the financial statements includes that information, this paragraph should be deleted. (As discussed in paragraph 7.28 of this SOP, auditors are strongly discouraged from issuing combined reports.)

**Exhibit D-2**

# Unqualified Opinion on Schedule of Federal Awards

[*Addressee*]

We have audited the financial statements of [*name of organization*] for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States.[2] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Our audit was made for the purpose of forming an opinion on the basic financial statements of [*name of organization*] taken as a whole. The accompanying Schedule of Federal Awards is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information in that Schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]
[*Date*]

*Notes*:

1. When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the financial statements on the supplementary data. Guidance on reporting in such circumstances is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), and SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1, AU sec. 552).

2. The phrase "and *Government Auditing Standards*, issued by the Comptroller General of the United States" must be included in the report on the Schedule of Federal Awards.

Exhibit D-3

# Report on the Internal Control Structure Based on an Audit of Financial Statements Performed in Accordance With GAS

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.[2] Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of [*name of organization*] for the year ended June 30, 19XX, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data in a manner that is consistent with the assertions of management in the financial statements.[3]

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[4]

We also noted other matters involving the internal control structure and its operation that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX.[5]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[6]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.
3. Paragraph 17 of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in a Financial Statement Audit*, prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards*.

   [*The first through the fourth paragraphs of the report are the same as those illustrated in exhibit D-3.*]

   Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

We noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.[5]

[*The last paragraph of the report is the same as the last paragraph of the report illustrated in exhibit D-3.*]

4. If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be modified as follows:

   However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of [*name of organization*] for the year ended June 30, 19XX.

   [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

5. If a separate letter has not been issued, this paragraph should be omitted.
6. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-4

# Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When the Auditor's Procedures Disclose No Reportable Instances of Noncompliance

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, providing an opinion on overall compliance with such provisions was not an objective of our audit of the financial statements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. See Chapter 5, paragraphs 5.15 through 5.20 of *Government Auditing Standards* for reporting criteria.
3. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-5**

# Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When Reportable Instances of Noncompliance Exist

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, providing an opinion on overall compliance with such provisions was not an objective of our audit of the financial statements. Accordingly, we do not express such an opinion. The results of our tests of compliance disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.[2]

[*Include paragraphs describing the instances of noncompliance noted.*]

We considered these instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. See Chapter 5, paragraphs 5.15 through 5.20 of *Government Auditing Standards* for reporting criteria.
3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-6

# Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When Uncertainty About the Effects of Noncompliance Exists

*[Addressee]*

We have audited the financial statements of *[name of organization]* as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to *[name of organization]* is the responsibility of *[name of organization]*'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of *[name of organization]*'s compliance with certain provisions of laws, regulations, contracts, and grants. However, providing an opinion on overall compliance with such provisions was not an objective of our audit of the financial statements. Accordingly, we do not express such an opinion. The results of our tests of compliance disclosed the following instances of noncompliance, the effects of which may be material to the financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in *[name of organization]*'s 19XX financial statements.[2]

*[Include paragraphs describing the instances of noncompliance noted.]*

We considered these instances of noncompliance in forming our opinion on whether *[name of organization]*'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.[3]

*[Signature]*

*[Date]*

*Notes:*

1. Describe any departure from the standard report.

2. The effect of the instances of noncompliance is considered when reporting on the basic financial statements and, if material to the basic financial statements, an explanatory paragraph similar to the following should be inserted after the opinion paragraph in the auditor's report on the financial statements:

   As discussed in note X, [*name of organization*] failed to comply with certain requirements applicable to the federal awards programs in which it participates. The financial statements do not include an adjustment for any liability that may result from the actions of the organization and federal agencies relative to these instances of noncompliance.

   Auditors should be aware that instances of noncompliance may be material, either individually or in the aggregate, warranting an adverse opinion on the financial statements.

3. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-7**

# Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When the Auditor Decides Not to Perform Any Tests of Compliance[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [*name of organization*]'s compliance with such provisions of laws, regulations, contracts, and grants.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

*Notes:*

1. This report is only appropriate in rare circumstances, based on assessments of materiality and audit risk, where the auditor may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants. (See paragraph 7.26 of this SOP for discussion of dating of reports.)
2. Describe any departure from the standard report.
3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-8

# Report on the Internal Control Structure Used in Administering Federal Awards

*[Addressee]*

We have audited the financial statements of *[name of organization]* as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] We have also audited *[name of organization]*'s compliance with requirements applicable to major federal programs, and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether *[name of organization]* complied with laws and regulations, noncompliance with which would be material to a major federal program.

In planning and performing our audits for the year ended June 30, 19XX, we considered *[name of organization]*'s internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on *[name of organization]*'s financial statements and on its compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-133. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal programs. We have addressed policies and procedures relevant to our audit of the financial statements in a separate report dated August 15, 19XX.

The management of *[name of organization]* is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles, and that federal awards programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal programs in the following categories: *[identify internal control structure categories]*.[2] For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.[3]

During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs.[4,5]

We performed tests of controls,[6] as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements; general requirements; and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters[7] involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to administer federal awards programs in accordance with applicable laws and regulations.

[*Include paragraphs describing the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that none of the reportable conditions described above is a material weakness.[8]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[9]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. See paragraph 7.7 for a discussion of categories to be identified. Also, see paragraphs 6.36 and 6.53 through 6.61 for specific and general requirements, respectively.

3. If a cyclical approach is used, the last sentence of this paragraph should be modified and the following paragraph added:

   Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor program expenditures administered by the organization as a whole. The nonmajor program expenditures not covered during the current year have been or are expected to be subject to such procedures at least once during the X-year cycle.

4. If the total amount expended under major programs is less than 50 percent of total federal awards expended during the year under audit, the auditor should follow the guidance in paragraph 5.23 of this SOP to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the sixth and seventh paragraphs of this report should be modified as follows:

   During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs and the following nonmajor programs: [*list appropriate nonmajor programs*].

   We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards, and the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

5. If the organization had no major programs during the year under audit, the auditor should follow the guidance in paragraph 5.25 of this SOP to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the second sentence of the first paragraph of the report, which refers to an audit of compliance with requirements applicable to major programs, would be omitted and the phrase "and about whether [*name of organization*] complied with laws and regulations, noncompliance with which would be material to a major federal program" should be omitted. Also, the phrase "and on its compliance with requirements applicable to major programs" should be omitted from the third paragraph. The sixth and seventh paragraphs of this report should be modified as follows:

   During the year ended June 30, 19XX, [*name of organization*] had no major programs and expended X percent of its total federal awards under the following nonmajor programs [*list appropriate nonmajor programs*]:

We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

6. When no tests of controls are performed for certain compliance requirements, this paragraph and those that follow should be replaced with the following:

Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the [*name of organization*]'s major federal programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For [*identify relevant federal programs*], we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with [*identify relevant compliance requirements*]. We did not perform such tests because the results of procedures we performed to obtain an understanding of the design of internal control policies and procedures and whether they have been placed in operation indicated that [*describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective*]. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect [*name of organization*]'s ability to administer federal programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level of risk that noncompliance with laws and regulations that would be material to a federal program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

7. When there are no material weaknesses and no reportable conditions noted, this paragraph and those that follow should be replaced with the following paragraphs:

Our consideration of the internal control structure policies and procedures used in administering federal awards would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal awards program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*name of organization*]. However, this report is also a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

8. If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major programs. The last sentence of this paragraph of the report should be modified as follows:

   However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of [*name of organization*]'s compliance with requirements applicable to its major programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated August 15, 19XX. [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

9. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-9**

# Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Programs

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have also audited [*name of organization*]'s compliance with the requirements governing [*list requirements tested*][2] that are applicable to each of its major federal programs, which are identified in the accompanying schedule of federal awards[3] for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[4]

In our opinion, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. Specific requirements generally pertain to the following matters:
   - Types of services allowed or not allowed
   - Eligibility

- Matching, level of effort, or earmarking
- Reporting
- Special tests and provisions
- Financial reports and claims for advances and reimbursements
- Amounts claimed or used for matching

3. Major programs should be clearly identified in the schedule of federal awards.

4. If there are no instances of noncompliance, this paragraph should be omitted. Immaterial instances of noncompliance may be communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the first sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

5. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-10

# Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Scope Limitation

[*Addressee*]

[*The first and second paragraphs are the same as those of the standard report on major program compliance illustrated in exhibit D-9.*]

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to [*name of organization*]'s compliance with those requirements by performing other auditing procedures.

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.*]

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-11

# Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Noncompliance

*[Addressee]*

*[The first three paragraphs are the same as those in the standard report on major program compliance illustrated in exhibit D-9.]*

The results of our audit procedures for *[identify the major program]* disclosed that *[name of organization]* did not comply with the requirement that *[name of organization]* match the funds received from *[identify the major program]*. In our opinion, *[name of organization]*'s matching of funds received from *[identify the major program]* is necessary for *[name of organization]* to comply with the requirements applicable to *[identify the major program]*.

*[The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.]*

In our opinion, except for those instances of noncompliance with the requirements applicable to *[identify the major program]* referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, *[name of organization]* complied, in all material respects, with the requirements governing *[list requirements tested]* that are applicable to each of its major programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.[1]

*[Signature]*

*[Date]*

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-12**

# Adverse Opinion on Compliance With Specific Requirements Applicable to Major Programs

*[Addressee]*

*[The first three paragraphs of the report are the same as those in the standard report on major program compliance illustrated in exhibit D-9.]*

*[Add a paragraph describing the reasons for the adverse opinion.]*

*[The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.]*

In our opinion, because of the noncompliance referred to in the fourth paragraph, [*name of organization*] did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

*[Signature]*

*[Date]*

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-13**

# Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Programs

[*Addressee*]

[*The first paragraph of the report is the same as the first paragraph in the report illustrated in exhibit D-9.*]

We were also engaged to audit [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements.

The management of [*name of organization*] has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-14**

# Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Uncertainties

*[Addressee]*

*[The first three paragraphs are the same as those of the standard report on major program compliance illustrated in exhibit D-9.]*

The results of our audit procedures for the [*name*] program disclosed that [*name of organization*] did not comply with the requirements that [*identify the requirements*]. In our opinion, [*name of organization*]'s compliance with this requirement is necessary for [*name of organization*] to comply with the requirements applicable to the [*name*] program.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the second paragraph of this report, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with requirements applicable to the [*name*] program referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

Resolving instances of noncompliance identified in the fourth paragraph of this report is the responsibility of [*name of organization*] and federal officials. The determination of whether the identified instances of noncompliance will ultimately result in a disallowance of costs cannot be presently determined. Accordingly, no adjustment for any disallowances that may result has been made to the federal program amounts listed in the accompanying schedule of federal awards and no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

*[Signature]*

*[Date]*

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-15**

# Report on Compliance With General Requirements—No Material Noncompliance Identified

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have applied procedures to test [*name of organization*]'s compliance with the following requirements applicable to its federal programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX: [*List the general requirements tested.*[2]]

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] has not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[4]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. General requirements involve the following matters:
   - Political activity
   - Davis-Bacon Act
   - Civil rights
   - Cash management
   - Federal financial reports
   - Allowable costs/cost principles

- Drug-free workplace
- Administrative requirements

The auditor should refer to the Compliance Supplement for additional information on the general requirements.

3. If there are no immaterial instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

4. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-16

# Report on Compliance With General Requirements When Material Noncompliance Is Identified

*[Addressee]*

*[The first three paragraphs are the same as those of the report on compliance with general requirements illustrated in exhibit D-15.]*

Material instances of noncompliance consist of failure to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material to [*indicate program(s) or financial statements*]. The results of our tests of compliance disclosed the material instances of noncompliance that are described in the accompanying Schedule of Findings and Questioned Costs.[1]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.[2]

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[3]

*[Signature]*

*[Date]*

*Notes:*

1. If, individually or collectively, the instances of noncompliance are also material to the basic financial statements, the report on compliance required by *Government Auditing Standards* (exhibit D-4) is modified as follows:

   *[First three paragraphs are the same as in the report illustrated in exhibit D-4.]*

The results of our tests of compliance disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards.*

[*Include paragraphs describing the instances of noncompliance noted.*]

We considered these instances of noncompliance in forming our opinion on whether the 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

2. The following is an illustration of the auditor's report when the auditor determines noncompliance is pervasive and the auditor is not able to provide negative assurance on general requirements.

[*First three paragraphs and last paragraph are the same as in the report illustrated above.*]

With respect to the items tested, [*name of organization*] complied with the requirements listed in the second paragraph, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that [*name of organization*] may not have complied with the requirements referred to in the second paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

3. If the report is not part of public record, this sentence should not be included in the report.

**Exhibit D-17**

# Report on Compliance With General Requirements When a Scope Limitation Exists

*[Addressee]*

*[The first two paragraphs are the same as those of the standard report on compliance with general requirements illustrated in exhibit D-15.]*

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of [*name of organization*]'s compliance with [*identify the requirement*] of [*name*] program, nor were we able to satisfy ourselves by alternative procedures as to [*name of organization*]'s compliance with those requirements of [*name*] program.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the [*identify the requirement*] of [*name*] program, [*name of organization*] complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[1]

*[Signature]*

*[Date]*

*Note:*

1. If the report is not part of the public record, this sentence should not be included in the report.

**Exhibit D-18**

# Report on Compliance With Specific Requirements Applicable to Nonmajor Program Transactions

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

In connection with our audit of the financial statements of [*name of organization*] and with our consideration of [*name of organization*]'s internal control structure used to administer federal programs, as required by Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, we selected certain transactions applicable to certain nonmajor federal programs for the year ended June 30, 19XX. As required by OMB Circular A-133, we performed auditing procedures to test compliance with the requirements governing [*list requirements tested*][2] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements.[3] However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]

[*Date*]

*Notes:*

1. Describe any departure from the standard report.
2. See note 2 to exhibit D-9.
3. The following is an illustration of the auditor's report when the auditor determines noncompliance for nonmajor program transactions is pervasive and the auditor is not able to provide assurance.

[*First two paragraphs and last paragraph are the same as in the report illustrated above.*]

The results of our tests indicate that, with respect to the items tested, [*name of organization*] complied with those requirements, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to nonmajor program transactions not tested by us, there is more than a relatively low risk that [*name of organization*] may not have complied with the requirements referred to in the preceding paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

4. If there are no instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be reported to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "However, we noted certain immaterial instances of noncompliance that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

5. If the report is not part of the public record, this sentence should not be included in the report.

## APPENDIX E

# Sample Not-for-Profit Organization Schedule of Federal Awards

### Community Action Agency
### Schedule of Federal Awards
### For the Year Ended June 30, 19XX

| *Federal Grantor / Pass-through Grantor / Program Title* | *Federal CFDA Number* | *Agency or Pass-through Number* | *Federal Expenditures* |
|---|---|---|---|
| U.S. Dept. of Health and Human Services | | | |
| Headstart (Note B) | 93.600 | 05CH5560/07 | $ 237,861* |
| | 93.600 | 05CH5560/08 | 200,000* |
| Subtotal | | | 437,861 |
| Pass-through From State Dept. of Human Services | | | |
| Community Services Block Grant | 93.792 | K1578 | 536,987* |
| Weatherization (Note A) | 93.818 | K4599 | |
| Subtotal—U.S. Dept. of Health and Human Services | | | 974,848 |
| Other Federal Awards | | | |
| ACTION: | | | |
| Pass-through State Department on Aging | | | |
| Foster Grandparents | 72.001 | 33924 | 80,987 |
| Total | | | $1,055,835 |

* Major program.

Note A: This item is intended to show that a program can be open without monies being received or expended during the audit period. Such programs should be included in the schedule.

Note B: Although not required, this breakout by grant will facilitate review and make the report more meaningful to users.

# Sample University Schedule of Federal Awards* †

## Browning Version University
## Schedule of Federal Awards
## For the Year Ended June 30, 19XX

| *Federal Grantor / Pass-through Grantor / Program Title* | *Federal CFDA Number‡* | *Agency or Pass-through Number* | *Federal Expenditures* |
|---|---|---|---|
| MAJOR PROGRAMS | | | |
| Research and Development: | | | |
| U.S. Dept. of Health and Human Services: | | | |
| Human Genome Research | 93.172 | | $ 400,528 |
| General Clinical Research | 93.333 | | 863,561 |
| Biomedical Research Support | 93.337 | | 450,218 |
| Other National Institutes of Health | — | | 780,745 |
| Health Resources and Services Administration | — | | 477,203 |
| Subtotal | | | 2,972,255 |
| U.S. National Foundation on the Arts and Humanities, National Endowment for the Humanities | — | | 56,186 |
| U.S. Agency for International Development | — | | 80,037 |
| Total Research and Development | | | 3,108,478 |
| Student Financial Assistance | | | |
| U.S. Dept. of Health and Human Services | | | |
| Nursing Student Loan (Note A) | 93.364 | | 1,000 |

* Cost sharing, matching, and grant-related revenue could also be added as a separate column to this schedule.

† The Bureau of Census, Single Audit Clearinghouse, plans to use the Schedule to compile federal assistance by the CFDA number.

‡ CFDA numbers may not be available for all programs (for example, National Endowment for the Humanities and U.S. Agency for National Development).

*(Continued)*

| *Federal Grantor / Pass-through Grantor / Program Title* | *Federal CFDA Number* | *Agency or Pass-through Number* | *Federal Expenditures* |
|---|---|---|---|
| U.S. Dept. of Education | | | |
| Guaranteed Student Loans (Note B) | 84.032 | | 0 |
| Pell Grants | 84.063 | | 3,006,655 |
| Total Student Financial Assistance | | | 3,007,655 |
| OTHER MAJOR PROGRAMS | | | |
| U.S. Dept. of Agriculture: | | | |
| Cooperative Extension Service | 10.500 | | 3,835,136 |
| Total Major Programs | | | 9,951,269 |
| NONMAJOR PROGRAMS | | | |
| Other Federal Assistance | | | |
| U.S. National Foundation on the Arts and Humanities | | | |
| Institute of Museum Services | — | | 10,500 |
| National Endowment for the Arts | | | |
| Irish Harp Festival | — | | 5,100 |
| Art Festival | — | | 11,900 |
| Subtotal | | | 27,500 |
| Pass-through State Dept. of Health | | | |
| U.S. Dept. of Agriculture Commodities (Note C) | 10.550 | 587G3 | 968 |
| Total Other Federal Assistance | | | 28,468 |
| Total Federal Assistance | | | $9,979,737 |

Note A: The university administers the following federal loan program:

| | *CFDA Number* | *Outstanding Balance at June 30, 1992* |
|---|---|---|
| Nursing Student Loan Program | 93.364 | $218,629 |

Total loan expenditures and disbursements of the Department of Health and Human Services student financial assistance program for the fiscal year are identified below:

| | *CFDA Number* | *Disbursements* |
|---|---|---|
| Nursing Student Loan Program | 93.364 | $118,629 |

The above expenditures for the Nursing Student Loan Program include disbursements and expenditures such as loans to students and administrative expenditures. The Schedule only includes administrative costs of the loan program.

Note B: During the fiscal year ending June 30, 1992, the University processed the following amount of new loans under the Guaranteed Student Loan Program (which includes Stafford Loans, Parents' Loans for Undergraduate Students, and Supplemental Loans for Students):

| | *CFDA Number* | *Amount Authorized* |
|---|---|---|
| Guaranteed Student Loans | 84.032 | $40,036,285 |

Note C: Nonmonetary assistance is reported in the Schedule based on the amount disbursed or received. As of June 30, 1992, the University had the following nonmonetary inventory:

| | |
|---|---|
| Food Commodities | $20,000 |

# APPENDIX F

# Sample Schedules of Findings and Questioned Costs

## *Example I:*

## Guaranteed Student Loan (GSL) Program —CFDA #84.032 (Questioned Cost—$10,000)

| *Loans* | *Population*[A] | | *Sample*[A] | | *Non-Compliance*[A] | |
|---|---|---|---|---|---|---|
| *Authorized* | *Size* | *Value* | *Size* | *Value* | *Size* | *Value* |
| Stafford | 821 | $2,328,565 | 25 | $69,600 | 2 | $5,500 |
| SLS | 388 | $ 970,653 | 25 | $65,000 | 1 | $2,500 |
| PLUS | 399 | $ 985,306 | 25 | $77,500 | 1 | $2,000 |

### *Condition*

Four students' files failed to contain a copy of the financial aid transcript from the institution that the student previously attended.

### *Criteria*

Until an institution receives a financial aid transcript from each eligible institution the student previously attended, the institution shall not release GSL or SLS proceeds to a student. [34 CFR 668.19(3)]

### *Effect*

The institution disbursed GSL funds to the students in the amount of $10,000, in violation of the provisions of the GSL program.

### *Cause*

Shortly after the students transferred into the institution, there was a change in personnel in the Student Financial Aid Office, which resulted in this required action to obtain the financial aid transcript to be overlooked.

### *Recommendation*

The University should contact the institution from which the students transferred to obtain the required financial aid transcripts. If the University fails to obtain the required transcripts, or if the transcripts show that any of the students exceeded annual or aggregate aid limits, the University should return all unallowable loan proceeds to the appropriate lender.

### *University's Comments*

We have made contact with the other institutions from which the four students transferred, and have made arrangements for receiving the required financial aid transcripts.

Note A: Presentation of population, sample size, and noncompliance is optional for immaterial findings.

## *Example II:*

## Agency for International Development (AID)
## (Note: AID has not been assigned a CFDA number)

### *Interest on Federal Advances and Timely Disbursement of Cash*

During 19XX, AID revised its directive on cash management to require that all federal advances be deposited in interest-bearing accounts and that the interest be remitted to the sponsor. The organization maintains interest-bearing domestic accounts and non-interest-bearing foreign accounts. We noted the remittance to the sponsors of interest earned by the organization on domestic cash accounts. As shown in the table below, the organization manages the advances so that additional interest will not be significant, even if all funds are invested in interest-bearing accounts. Overseas, the organization does not always use interest-bearing accounts, because it is not practical in all countries.

In our testing for the timely disbursement of cash drawn on the Federal Reserve Letter of Credit, we noted compliance with reasonable guidelines (within three days for domestic accounts and within thirty days for foreign accounts), as follows:

| | *Domestic Accounts* | | *Foreign Accounts* | |
|---|---|---|---|---|
| | *19X1* | *19X0* | *19X1* | *19X0* |
| Drawdowns selected for testing | $675,667 | $1,858,588 | $2,922,966 | $645,758 |
| Drawdowns not fully expended within time guidelines | 18% | 21% | 5% | 3% |

To be in full compliance with AID directives, the organization should place all funds held overseas in interest-bearing accounts.

### *Management Response*

We believe that the corrective action taken regarding the timely disbursement of cash is sufficient to achieve substantial compliance with AID directives. The monitoring of this control function will be given greater emphasis to increase compliance.

At this time, three of the thirteen field offices maintain interest-bearing accounts. All other field locations have indicated that interest-bearing accounts carry restrictions that would impede their ability to meet operational requirements (that is, restrictions on the receipt of infusions of external funds, the number of withdrawals per month, and the availability of commercial interest-bearing accounts). We will continue our investigation concerning interest-bearing accounts with these offices to determine the appropriate action.

## *Example III:*

## Headstart — CFDA #93.600
## (Questioned Cost — $16,400)

### *Finding*

The grant financial award stated that the award was for the specific purposes contained in the approved budget. The approved budget specified $15,000 for a van and $1,400 for an audiometer. Neither piece of equipment was purchased as evidenced by the inventory. The funds budgeted for equipment acquisition were used to pay for increased field trips approved by the Department without modification to the budget. This occurred because management did not have adequate procedures in place to monitor proposed expenditures against the budget. The grantee should return the $16,400 expended.

### *Grantee Comment*

The institution concurs with this comment. The $16,400 will be returned to the granting agency and procedures will be established to prevent a recurrence of this situation.

Note: *Follow Up On Prior-Year Findings*. We have reviewed the findings reported in the audit of Browning Version University for the year ended June 30, 19XX. Prior-year findings that have not been corrected are restated in the report and identified as both a current and a prior-year finding. All other findings from prior years have been corrected.

## APPENDIX G

# Illustrative Audit Engagement Letter

[*Addressee*]

This letter sets forth our understanding of the terms and objectives of our engagement, the nature and scope of the services we will provide, and the related fee arrangements.

We will audit the organization's financial statements as of and for the year ended [*date*], in accordance with generally accepted auditing standards, the standards for financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States and with the provisions of Office of Management and Budget Circular A-133, dated March 16, 1990. The objective of an audit carried out in accordance with such standards and regulations is (1) the expression of our opinion concerning whether the financial statements present fairly, in all material respects, the financial position, changes in net assets, and cash flows of the organization in conformity with generally accepted accounting principles; (2) a report on our determination that the internal control structure provides reasonable assurance of compliance with federal and other laws and regulations; and (3) the expression of an opinion on whether the organization complied with specific terms and conditions of its major federal award programs.

As part of our audit, we will consider the organization's internal control structure and assess control risk, as required by generally accepted auditing standards, for the purpose of establishing a basis for determining the nature, timing, and extent of auditing procedures necessary for expressing our opinion concerning the financial statements, and not to provide assurance on the internal control structure. The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. To fulfill this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs for internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We will prepare a separate written report on our understanding of the organization's internal control structure and the assessment of control risk made as part of the financial statement audit. Our report will include (1) the scope of our work in obtaining an understanding of the internal control structure and in assessing the control risk and (2) the reportable conditions, including the identification of material weaknesses identified as a result of our work in understanding and assessing the control risk. As required by OMB Circular A-133, we will also prepare a written report on our understanding, assessment, and testing of the internal control structure as it relates to major federal award programs.

Our audit will include procedures designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. As you are aware, however, there are inherent limitations in the auditing process. For example, audits are based on the concept of selective testing of the data being examined and are, therefore, subject to the limitation that such matters, if they exist, may not be detected. Also, because of the characteristics of irregularities, including attempts at concealment through collusion and forgery, a properly designed and executed audit may not detect a material irregularity.

Similarly, in performing our audit, we will be aware of the possibility that illegal acts may have occurred. However, it should be recognized that our audit provides no assurance that illegal acts generally will be detected, and only reasonable assurance that illegal acts having a direct and material effect on the determination of financial statements amounts will be detected.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective is not to provide an opinion on overall compliance with such provisions.

As required by *Government Auditing Standards*, we will report on our tests of compliance with applicable laws and regulations. This report will contain a description of all material instances of noncompliance detected.

Likewise, compliance with provisions of laws, regulations, contracts, and grants that govern federal programs is the responsibility of management. As required by OMB Circular A-133, we will determine and report on whether the organization complied in all material respects with the laws and regulations that apply to its major federal award programs. With regard to transactions selected from nonmajor programs, our report on compliance will obtain a statement of positive and negative assurance, as discussed above.

At the conclusion of the engagement, [*name of organization*]'s management will provide to us a representation letter that, among other things,[1] will confirm management's responsibility for the preparation of the financial statements in conformity with generally accepted accounting principles, the availability of financial records and related data; compliance with provisions of laws, regulations, contracts, and grants that govern federal programs, the completeness and availability of all minutes of board of directors (and committee) meetings; and the absence of irregularities involving management or those employees who have significant roles in the control structure.

We understand that our reports on the internal control structure and on compliance with laws and regulations are intended for the information of the audit committee, management, and other within [*name of organization*] and [*specify legislative or regulatory body*].

Our fees for the audit will be [*describe fee arrangement*]. We anticipate completing the engagement by [*describe timetable*], unless unexpected factors are encountered. This timetable has been discussed with and agreed to by your [*internal audit and*] accounting department[s], which will provide assistance to us in the audit. Should circumstances prevent [*name of organization*] from providing this assistance, our timetable and fee are likely to be affected. [*On fixed-fee engagements, the auditor may include wording indicating that he or* *she may have to revise the fee estimate and timetable for unexpected factors of which he or she becomes aware after the engagement has begun.*]

We shall be pleased to discuss this letter with you.

[*Signature*]

[*Date*]

*Note:*

1. Other matters may be included. This sample letter should be modified as necessary.

# Glossary

***AICPA.*** American Institute of Certified Public Accountants.

***AID.*** Agency for International Development.

***Award.*** Defined in OMB Circular A-133 as federal financial assistance (see below) and federal cost-type contracts used to buy services or goods for the use of the federal government. It includes both awards received directly or indirectly through recipients (pass-through funds). It does not include procurement contracts to vendors under grants or subcontracts used to buy goods or services.

***CFDA.*** Catalog of Federal Domestic Assistance.

***CFR.*** Codified Federal Regulation.

***Cognizant agency.*** A federal agency designated by the OMB to provide general oversight of an organization that receives federal funds. Cognizant agencies have certain specified responsibilities, including the coordination of audits of the organization; see the section entitled "Responsibilities of the Cognizant Agency" in chapter 3 of this SOP.

***Compliance Supplements.*** Published by the OMB as a supplement to OMB Circular A-128, *Compliance Supplement for Single Audits of State and Local Governments* (revised in April 1990). It specifies the general and specific program compliance requirements and suggested audit procedures for sixty-two federal financial assistance programs. The OMB published a supplement to OMB Circular A-133, *Compliance Supplement for Audits of Institutions of Higher Learning and Other Nonprofit Institutions*.

***Coordinated audit approach.*** An audit wherein the independent auditor and other federal and nonfederal auditors, consider each other's work in determining the nature, timing, and extent of his or her own auditing procedures. A coordinated audit must be conducted in accordance with *Government Auditing Standards* and meet the objectives and reporting requirements set forth in paragraphs 12(b) and 15, respectively, of the Attachment to Circular A-133. The objective of the coordinated audit approach is to minimize duplication of audit effort, but not to limit the scope of the audit work so as to preclude the independent auditor from meeting the objectives set forth in paragraph 12(b) or issuing the reports required in paragraph 15 in a timely manner. (Also referred to as a joint audit, although this term more commonly refers to audits carried out by two or more independent CPA firms.)

***CPE.*** Continuing Professional Education.

***Cyclical approach.*** Method by which the auditor obtains an understanding of internal control structure policies and procedures applicable to nonmajor programs over a number of years when multiple operating components of an NPO administer a large number of nonmajor programs. Each nonmajor program for which the cyclical approach is used should be covered at least once every three years. In the first year of the review cycle, the auditor should obtain an understanding of the internal control structure policies and procedures for any program of which he or she has not obtained an understanding. Also, the auditor should obtain an understanding of policies and procedures for new nonmajor programs the first year that the program is active. If a cyclical approach is used, the auditor's report on the internal control structure should be modified to clearly describe the coverage provided for nonmajor programs.

***FAR.*** Federal Acquisition Regulations.

***Federal financial assistance.*** Assistance provided to an organization by a federal agency in such forms as grants of cash and other assets, loans, loan guarantees, and interest-rate subsidies. The term includes pass-through assistance but does not include direct federal cash assistance to individuals.

***Findings.*** *Government Auditing Standards* defines findings as the result of information development—a logical pulling together of information about an organization, program, activity, function, condition, or other matter that was analyzed or evaluated. It also states that factual data supporting all findings should be presented accurately and fairly in the auditor's report and that these findings should be adequately supported by sufficient evidence in the working papers.

***FSR.*** Financial status report.

***GAAP.*** Generally accepted accounting principles.

***GAAS.*** Generally accepted auditing standards.

***GAO.*** The United States General Accounting Office. Its main purposes are to (1) assist Congress in carrying out legislative and oversight responsibilities; (2) carry out legal, accounting, auditing, and claims-settlement functions with respect to federal government programs; and (3) make recommendations to provide for more efficient and effective government operations.

***GAS.*** *Government Auditing Standards.*

***General requirements.*** Described in the Compliance Supplements as "those requirements that involve significant national policy and of which failure to comply could have a material impact on an organization's financial statements." Accordingly, tests for compliance with these requirements "should be included as a part of every audit of state, local, and tribal governments that involves federal financial assistance."

***HHS.*** U.S. Department of Health and Human Services.

***Joint audit.*** An audit for which the recipient of federal funds, the cognizant (or largest funding) agency, and the auditors have agreed on their respective audit scope. (Also referred to as a coordinated audit.)

***Major program.*** A program in which total expenditures are the larger of 3 percent of total federal funds expended or $100,000. Each of the following categories of federal award constitutes a major program if over the threshold:

1. Research and development
2. Student financial assistance
3. Individual awards not in the student aid or research-and-development category

***Nonmajor program.*** Defined by the Single Audit Act as any federal award program that does not meet the specified criteria of a major program.

***NPO.*** Non-profit (or not-for-profit) organization.

***OASC.*** Office of Assistant Secretary, Comptroller.

***OMB.*** The United States Office of Management and Budget.

***OMB Circular A-21,* Cost Principles for Educational Institutions.** Issued to provide that federal assistance programs provided to educational institutions bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

***OMB Circular A-110,* Uniform Requirements for Grants to Universities, Hospitals and Other Nonprofit Organizations.** Issued to establish standards (such as insurance requirements, record retention requirements, banking requirements, and so on) for maintaining consistency and uniformity among federal agencies in the administration of grants to and agreements with public and private institutions of higher education, public and private hospitals, and other quasi-public and private nonprofit organizations. It does not apply to grants, contracts, and other agreements between the federal government and units of state and local governments.

***OMB Circular A-122,* Cost Principles for Nonprofit Organizations.** Issued to provide that federal assistance programs provided to nonprofit organizations bear their fair share of costs by defining costs that are allowable and unallowable for that assistance. This circular does not apply to—

1. Colleges and universities.
2. State, local, and Indian tribal governments.
3. Hospitals.

***OMB Circular A-128,* Audits of State and Local Governments.** Issued to facilitate the implementation of the Single Audit Act of 1984. It establishes audit requirements and defines federal responsibilities for implementing and monitoring these requirements.

***OMB Circular A-133,* Audits of Institutions of Higher Education and Other Nonprofit Institutions.** Establishes audit requirements and defined federal responsibilities for implementing and monitoring federal requirements.

***Organization-wide audit.*** Under Circular A-133, it has two main components—an audit of the financial statements and an audit of federal awards. Each component results in a variety of audit reports. The single-audit concept is described in Circular A-133 as an organization-wide audit.

***Oversight agency.*** The federal agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency. For those entities that do not receive any direct funding, the federal agency with predominant indirect funding will assume the responsibilities of the oversight agency. The oversight agency may assume some or all of the responsibilities normally performed by a cognizant agency.

***Pass-through funds.*** Funds received by subrecipients indirectly from the federal government through a primary recipient.

***PCIE.*** President's Council on Integrity and Efficiency.

***Provider.*** A person or entity that undertakes to provide health care services.

***Questioned costs.*** Defined in the Inspector General Act Amendments of 1988 as (1) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds; (2) a finding that, at the time of the audit, such cost is not supported by adequate documentation; or (3) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

***R&D.*** Research and development.

***SAS.*** Statement on Auditing Standards.

***SFA.*** Student financial aid.

***Single Audit Act of 1984.*** The United States statute (Public Law 98-502) that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. These requirements focus on a single coordinated audit of the aggregate federal financial assistance programs. The requirements include—

1. An audit of the general-purpose financial statements.
2. Additional tests for compliance with applicable laws and regulations related to federal assistance programs received.
3. Reviews of the internal control system for federal financial assistance received.

***SOP.*** Statement of Position.

***Specific requirements.*** Defined in the Compliance Supplement as those requirements that pertain to the following categories:

1. Types of services allowed or not allowed
2. Eligibility
3. Matching, level of effort, or earmarking
4. Reporting
5. Special tests and provisions

***Subrecipient.*** An entity receiving government financial assistance when the assistance is initially received by another entity that distributes the assistance for the government program that created and provided the assistance.

# Appendix C

## *Information Sources*

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

## Information Sources

| Organization | General Information | Fax Services | Electronic Bulletin Board Services |
|---|---|---|---|
| **American Institute of Certified Public Accountants** | *Order Department*<br>Harborside Financial Center<br>201 Plaza Three<br>Jersey City, NJ 07311-3881<br>(800) TO-AICPA<br>or (800) 862-4272<br><br>Information about AICPA CPE programs is available through the AICPA CPE Division (extension 3) and the AICPA Meetings and Travel Division: (201) 938-3232. | *24 Hour Fax Hotline*<br>(201) 938-3787 | *Accountants Forum*<br>This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account, call (800) 524-3388 and ask for the AICPA package or rep. 748. |
| **Financial Accounting Standards Board** | *Order Department*<br>P.O. Box 5116<br>Norwalk, CT 06856-5116<br>(203) 847-0700, ext. 10 | | |
| **U.S. Office of Management and Budget** | Office of Administration<br>Publications Office<br>Room 2200<br>New Executive Office Building<br>Washington, D.C. 20503<br>(202) 395-7332 | | OMB has a home page on the World Wide Web. The address is http://www.whitehouse.gov/wh/EDP/OMB:<br><br>An alternate address is http://www.sbaonline.sba.gov/Ignet<br><br>For information concerning publications, standards, and exposure drafts released for comments by Inspectors General:Gopher//Gopher.Financenet.gov:70/1 |
| **National Association of College and University Business Offices** | One Dupont Circle<br>Suite 500<br>Washington, D.C. 20036<br>(202) 861-2500<br>(202) 861-2583 (f) | | *Electronic Bulletin Board Service*. Modem access: (202) 861-8400. Internet access: telnet to bbs.nacubo.nche.edu. IP address: 198.76.77.2 (Can also be accessed through the Ignet.) |

| Organization | General Information | Fax Services | Electronic Bulletin Board Services |
|---|---|---|---|
| **National Health Council** | 1730 M Street, NW<br>Suite 500<br>Washington, D.C 20036<br>(202) 785-3910<br>(202) 785-5923 (f) | | |
| **Other** | | | The *Rutgers Bulletin Board* on the World Wide Web includes various accounting related databases. The address for the home page is http://www.rutgers.edu/accounting/raw.html. The address for information concerning the FASB is http://www.rutgers.edu/accounting/raw.html/fasb/faf.htm |
| **U.S. General Accounting Office** | *Superintendent of Documents*<br>U.S. Government Printing Office<br>Washington, DC 20401-0001<br>(202) 512-1800<br>(202) 512-2250 (f) | | *U.S. Government Printing Office's The Federal Bulletin Board*<br>Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account.<br>User assistance line: (202) 512-1530<br>(202) 512-1387 (d)<br>Telnet via internet: federal.bbs.gpo.gov 3001<br>(Can also be accessed through the Ingnet.) |

# Appendix D

## *Schedule of Changes Made to Not-for-Profit Organizations*

| Reference | Change | Date |
|---|---|---|
| Chapter 1 | Revised to reflect the issuance of recent authoritative guidance; Footnotes 7 and 8 deleted and subsequent footnote renumbered. | June, 1997 |
| Paragraph 2.01 | Revised to reflect the Single Audit Act Amendments of 1996. | June, 1997 |
| Paragraph 2.26 (footnote *) | Added to reflect the issuance of SAS No. 82. | June, 1997 |
| Paragraph 2.32 | Revised to reflect the Single Audit Act Amendments of 1996. | June, 1997 |
| Paragraph 2.33 | Revised to reflect the Single Audit Act Amendments of 1996; Conformed to the terminology used in SAS No. 78. | June, 1997 |
| Paragraph 2.34 | Conformed to the terminology used in SAS No. 78; Footnote 8 revised to reflect the Single Audit Act Amendments of 1996. | June, 1997 |
| Paragraph 2.38 (footnote 9) | Deleted. | June, 1997 |
| Paragraph 2.46 | Revised to reflect the Single Audit Act Amendments of 1996. | June, 1997 |
| Paragraph 5.05 and footnote 6 | Added to reflect the issuance of FASB Interpretation No. 42; Subsequent paragraphs and footnotes renumbered. | June, 1997 |
| Paragraph 8.24 (footnote 11) | Revised to reflect the issuance of FASB Statement No. 126. | June, 1997 |
| Paragraph 14.15 | Revised to reflect the Single Audit Act Amendments of 1996; Conformed to the terminology used in SAS No. 78. | June, 1997 |
| Appendix A (footnote 2) | Added. | June, 1997 |

# Glossary

**agent.** An entity acting for and on behalf of a principal, which may be either a resource provider or a beneficiary.

**annuity gift.** A transfer of assets to a not-for-profit organization in connection with a split-interest agreement that is in part a contribution and in part an exchange transaction. The organization accepts the contribution and is obligated to make periodic stipulated payments to the donor or a third-party beneficiary for a specified period of time, usually either a specified number of years or until the death of the donor or third-party beneficiary.

**annuity trust.** See *charitable remainder trust.*

**board designated.** See *designated net assets* and *endowment fund.*

**charitable lead trust.** A trust established in connection with a split-interest agreement, in which the not-for-profit organization receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

**charitable remainder trust.** A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust.

**collections.** Works of art, historical treasures, or similar assets that are (*a*) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (*b*) protected, kept unencumbered, cared for, and preserved, and (*c*) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

**conditional promise to give.** A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

**contribution.** An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

**corpus.** The principal amount of a gift or trust. Usually refers to the portion of a split-interest gift or an endowment fund that must be maintained over a specified period or in perpetuity.

**designated net assets.** Unrestricted net assets subject to self-imposed limits by action of the governing board. Designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses.

**donor-imposed condition.** A donor stipulation that specifies a future and uncertain event whose occurrence or failure to occur give the promisor a right of return of the assets it has transferred or releases the promisor from its obligation to transfer its assets.

**donor-imposed restriction.** A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A restriction on an organization's use of the asset contributed may be temporary or permanent.

**endowment fund.** An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment, which is to provide a permanent source of income, or a term endowment, which is to provide income for a specified period. The portion of a permanent endowment that must be maintained permanently—not used up, expended, or otherwise exhausted—is classified as permanently restricted net assets. The portion of a term endowment that must be maintained for a specified term is classified as temporarily restricted net assets. An organization's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes referred to as funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets.

**equity.** See *net assets*.

**functional classification.** A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

**funds functioning as endowment.** Unrestricted net assets earmarked by an organization's governing board, rather than restricted by a donor or other outside agency, to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets. The governing board has the right to decide at any time to expend the principal of such funds. (Sometimes referred to as quasi-endowment funds.) See also *designated net assets*.

**fund raising activities.** Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

**funds held in trust by others.** Resources held and administered, at the direction of the resource provider, by an outside trustee for the benefit of the organization, frequently in connection with a split-interest agreement or permanent endowment.

**gift annuity.** See *annuity gift*.

**life income agreement.** A form of split-interest agreement. See *annuity gift* and *charitable remainder trust*.

**life tenant.** One who possesses a life-use right to property, frequently used in connection with a split interest agreement.

**natural expense classification.** A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

**net assets.** The excess or deficiency of assets over liabilities, classified according to the existence or absence of donor-imposed restrictions.

**net asset class(es).** The classification of net assets based upon the existence or absence of donor-imposed restrictions. See also *permanently restricted net assets*, *temporarily restricted net assets*, and *unrestricted net assets*.

**net investment (equity) in land, buildings, and equipment.** The total carrying value (after accumulated depreciation) of all property, plant, and equipment, less directly related liabilities. This amount is exclusive of real properties that are held for investment purposes.

**nonreciprocal transfer.** A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange.

**not-for-profit organization.** An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees ([FASB Statement of Financial Accounting] Concepts Statement No. 4, paragraph 6). Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans (FASB Concepts Statement No. 4, paragraph 7).

**permanent restriction.** A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

**permanently restricted net assets.** The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

**promise to give.** A written or oral agreement to contribute cash or other assets to another entity. A promise to give may be either conditional or unconditional.

**program services.** The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs.

**quasi-endowment.** See *funds functioning as endowment.*

**reclassifications.** Transfers of amounts from one net asset class to another, usually as a result of the release or lapsing of restrictions.

**remainder trust.** See *charitable remainder trust.*

**remainderman.** The recipient of the corpus (remaining principal) of a trust upon termination.

**restricted support.** Donor-restricted revenues or gains from contributions that increase either temporarily restricted net assets or permanently restricted net assets. See also *unrestricted support.*

**restricted net assets.** Resources whose use is restricted by donors as contrasted with those over which the organization has complete control and discretion. Restricted net assets may be permanently or temporarily restricted.

**spending-rate.** The portion of total return on investments used for fiscal needs of the current period, usually used as a budgetary method of reporting returns of investments. It is usually measured in terms of an amount or a specified percentage of a moving average market value. Typically, the selection of a spending rate emphasizes (*a*) the use of prudence and a systematic formula to determine the portion of cumulative investment return that can be used to support fiscal needs of the current period and (*b*) the protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used.

**split-interest agreement.** Trust or other arrangements initiated by donors under which not-for-profit organizations receive benefits that are shared with either the donor or third party beneficiaries. These gifts include lead interests (see *charitable lead trust*) and remainder interests (see *charitable remainder trust, annuity gift,* and *annuity trust*).

**stipulation.** A statement by a donor that creates a condition or restriction on the use of transferred resources.

**supporting activities.** Activities other than program services. The primary supporting activities are management and general, fund raising, and membership development activities.

**temporary restriction.** A donor-imposed restriction that permits the donee organization to use up or expend the donated assets as specified and is satisfied either by the passage of time or by actions of the organization.

**temporarily restricted net assets.** The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (*c*) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

**term endowment.** A donor-restricted contribution that must be maintained for a specified term.

**total return.** A measure of investment performance that focuses on the overall return on investments, including interest and dividend income as well as realized and unrealized gains and losses on investments. Frequently used in connection with a spending-rate formula to determine how much of that return will be used for fiscal needs of the current period.

**unconditional promise to give.** A promise to give that depends only on passage of time or demand by the promisee for performance.

**unrestricted net assets.** The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

**unrestricted support.** Revenues or gains from contributions that are not restricted by donors. See also *restricted support*.

**voluntary health and welfare organizations.** Organizations formed for the purpose of performing voluntary services for various segments of society. They are tax exempt (organized for the benefit of the public), supported by the public, and operated on a "not-for-profit" basis. Most voluntary health and welfare organizations concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare organizations include those not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services.

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*Brokers and Dealers in Securities*   No. 012179BK
*Audits of Casinos*   No. 013147BK
*Common Interest Realty Associations*   No. 012485BK
*Construction Contractors*   No. 012093BK
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